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PROPOSALS RELATING TO EXCISE TAXES

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

APRIL 21, 1986

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PROPOSALS RELATING TO EXCISE TAXES

MONDAY, APRIL 21, 1986

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Chafee, Durenberger, Symms, Long, Matsunaga, Baucus, Mitchell, and Pryor.

[The press release announcing the hearing, background material on the chairman's tax reform proposal relating to excise taxes and tariffs, and the written prepared statement of Senator Mitchell follow:]

[Press Release No. 86-025]

PRESS RELEASE

For Immediate Release April 7, 1986.

FINANCE COMMITTEE TO HOLD HEARING ON EXCISE TAXES

Committee on Finance Chairman Bob Packwood (R-Oregon) announced today that the Committee will hold a hearing on provisions contained in the Chairman's tax reform proposal affecting the deductibility of federal excise taxes and tariffs, taxation of wine at rates equivalent to beer, and adjustment of alcohol, tobacco and fuel excise taxes to reflect increases in price.

The hearing will be held at 9:30 a.m. on Monday, April 21, 1986 in Room SD-215 of the Dirksen Senate Office Building.

OVERVIEW OF CERTAIN PROVISIONS IN THE CHAIRMAN'S TAX REFORM PROPOSAL RELATING TO EXCISE TAXES AND TARIFFS

Scheduled for a Hearing

Before the

SENATE COMMITTEE ON FINANCE

on April 21, 1986

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

April 18, 1986

JCX-4-86

I. SUMMARY

The Senate Committee on Finance, as part of its consideration of tax reform proposals, has scheduled a public hearing on April 21, 1986, on certain provisions of Chairman Bob Packwood's tax reform proposal that relate to Federal excise taxes and tariffs. The Chairman's proposal includes three principal changes concerning excise taxes and tariffs.

First, amounts paid as Federal excise taxes and tariffs would not be deductible for Federal income tax purposes. Under present law, Federal excise taxes and tariffs incurred in the conduct of a trade or business or for the production of income may be deductible as part of the cost of goods sold, as ordinary and necessary costs of doing business or producing income, or as part of the basis for depreciation or amortization deductions. Federal excise taxes and tariffs that are not incurred in a business or in producing income are not deductible for Federal income tax purposes.

Second, the rate of excise tax on certain types of wine would be made equivalent to the rate at which beer is taxed, based on alcohol content.

Third, excise tax rates applicable to alcohol products, tobacco products, and motor fuels would be adjusted to reflect price changes.

This document,[1] prepared by the staff of the Joint Committee on Taxation, contains background information for use by the Committee in its consideration of these provisions.

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[1] This document may be cited as follows: Joint Committee on Taxation, Overview of Certain Provisions in the Chairman's Tax Reform Proposal Relating to Excise Taxes and Tariffs (JCX-4-86), April 18, 1986.

II. NONDEDUCTIBILITY OF FEDERAL EXCISE TAXES AND TARIFFS

Present Law

Overview of excise taxes

Federal excise taxes are imposed on the manufacture, sale, or use of a variety of goods and services, and on certain occupations.

Commodities subject to Federal excise taxes include alcoholic beverages (distilled spirits, wine, and beer), tobacco products (cigars and cigarettes), motor fuels (gasoline, diesel, and special motor fuels), heavy tires and trucks, coal, crude oil, sport fishing equipment, bows and arrows, firearms and ammunition, gas guzzling automobiles, and deep seabed minerals. Services subject to Federal excise taxes include domestic air passenger and cargo transportation, communications (telephone) services, and foreign insurance policies.

In addition to the transactional excises on certain commodities and services, an annual use tax applies to heavy highway vehicles. Also, excise taxes apply to certain occupations (alcoholic beverages, certain firearms, and wagering).

Revenues from some of the current Federal excise taxes are dedicated to specific trust funds in the Treasury, and thus are reserved for specified expenditure purposes (e.g., highways, airports and airways, black lung disability benefits, and inland waterways).

Rates, incidence of excise taxes

Federal excise taxes generally are imposed at a prescribed rate per commodity unit (e.g., $12.50 per proof gallon of distilled spirits), a prescribed percentage of the selling price (e.g., eight percent of the air passenger ticket price), or a variant of these basic rate structures (e.g., $1.10 per ton for underground mined coal, up to a maximum of 4.4 percent of the coal's selling price). Occupational excise taxes are imposed on an annual basis (e.g., $123 per year for wholesale beer dealers).

Excise taxes are imposed, in various cases, at the manufacturer (producer) level or importer level; at the wholesale level; at the retail (or service provider) level; or on the taxable use of a product or article if no sale occurs. Excise tax may be imposed directly on the business engaged in the production or activity subject to tax. In other instances, tax is imposed on the purchaser, with the seller acting as a tax collection agent for the Government.

Appendix A lists presently imposed Federal excise taxes, categorized according to point of imposition as follows: (1) taxes imposed on manufacturers (producers) or importers; (2) taxes imposed on retailers or service providers; (3) taxes imposed on persons paying for services; (4) taxes imposed on use; and (5) taxes imposed on an occupation. Appendix A also indicates whether the excise tax revenues are dedicated to a trust fund.

Overview of tariffs

Tariffs, or customs duties, are imposed on various categories of articles that are imported into the customs territory of the United States (including the 50 States, the District of Columbia, and Puerto Rico). Tariffs are imposed pursuant to the Tariff Act of 1930 (19 U.S.C. sec. 1202 et seq.), and may be subject to international limitations pursuant to the General Agreement on Tariffs and Trade (GATT).

Tariffs generally are imposed at a uniform rate for imports from most noncommunist countries. Lower rates apply to certain imports from developing countries and other specified countries; higher rates apply to imports from certain communist nations. Imports from U.S. insular possessions may be made duty-free if the imported product is not comprised primarily of foreign materials.

Liability for tariffs is imposed on the "importer of record" of a given article or substance. The importer of record may be the owner, purchaser, or consignee of the merchandise at the time of import, or a licensed customs broker. The importer of record may be a person not subject to U.S. income tax under present law.

The value and rates of tariffs on selected major commodity groups are summarized in Appendix C.

Income tax treatment of payors of excise taxes and tariffs

a. Deductible taxes and tariffs

In general.--Federal excise taxes and tariffs are deductible for Federal income tax purposes when incurred in the conduct of a trade or business or for the production of income. Payments of excise taxes and tariffs incurred in a business or income-producing activity may be taken into account for Federal income tax purposes in one of several ways.

Providers of goods or services may treat excise taxes or tariffs associated with providing the goods or services as a cost of sales or of providing the service. Other taxpayers may treat payments of excise taxes and tariffs as giving rise to current deductions, may capitalize them as part of the basis of an asset, or may absorb them as inventory costs. Generally, the treatment of these amounts corresponds to the treatment of the goods or services to which the tax or tariff relate.

If a provider of goods or services collects and remits an excise tax as the government's agent (this is the case for the excise taxes on telephone services, air cargo, and air passengers), the provider does not take the tax amount into account for Federal income tax purposes. In such circumstances, the collection of the tax or tariff is not an item of income, and its remittance to the Government is not an item of cost or expense. Thus, the tax or tariff is not recorded as an item affecting taxable income.

Providers of goods.--Excise taxes or tariffs imposed on the manufacture or sale of a product (e.g., distilled spirits) may be treated as a cost of goods sold. In these cases, any amount that is collected from customers purchasing the product on account of the tax or tariff must be included in gross receipts in computing the provider's taxable income.

The windfall profit tax currently is deductible under a specific Code provision (sec. 164(a)(5)).

Other taxpayers.--A business may be allowed current deductions for excise taxes and tariffs as ordinary and necessary business expenses (sec. 162) or as expenses paid or incurred for the production of income (sec. 212). Generally, this treatment is available if the product or service to which the tax or tariff relates also is deductible currently, and in the case of occupational excise taxes.

If an excise tax or tariff is paid or incurred in order to obtain an asset the cost of which is capitalized, the tax or tariff normally is included as part of the capitalized cost of the asset. The tax or tariff then is recovered (through depreciation deductions) in the same manner and at the same rate as the other capitalized costs of acquiring the asset.

Excise taxes and tariffs paid or incurred in connection with items of inventory are subject to the absorption rules applicable to other inventory costs. Generally, the determination of whether the tax or tariff is deducted currently or is absorbed as part of the cost of inventory follows the treatment the taxpayer uses for financial accounting purposes (Treas. Reg. sec. 1.471-11). Items that are included in inventory costs are deducted at the time the inventory is sold or otherwise disposed of.

b. Nondeductible taxes and tariffs

Federal excise taxes and tariffs that are not incurred in a trade or business or for the production of income are not deductible for Federal income tax purposes.

Federal excise taxes imposed under chapters 41-44 and 46[2] of the Code are not deductible for Federal income tax purposes (sec. 275(a)(6)). Also, the Code disallows deductions for Federal income taxes, estate and gift taxes, and Federal war profits or excess profits taxes (sec. 275(a)(2)).

c. Non-U.S. persons

Non-United States persons who import products subject to excise taxes and tariffs are payors of these taxes and tariffs. The rules governing liability for Federal income tax are, in some cases, different than the rules governing liability for excise taxes and tariffs. Thus, in these cases, payors of excise taxes or tariffs may not, under present law, be U.S. income tax payors.

The United States may subject certain foreign persons to Federal income tax, either on a gross basis or on a net basis. Gross basis taxation occurs if the foreign person is not engaged in a U.S. trade or business and receives U.S.-source interest, dividends, or other fixed or determinable types of income. In these instances, the person remitting the income (or otherwise having control over the income) withholds U.S. tax at a 30-percent rate, or such lower rate as may be provided by an income tax convention between the United States and a foreign country. (Some interest is exempt from tax in the hands of foreign persons.) In these cases, the foreign person is not allowed to account for any costs or expenses paid. Thus, a foreign person who pays an excise tax or tariff in connection with an item of income that is subject to a gross basis tax is not allowed to reduce the amount subject to tax by the excise tax or tariff.

Net basis taxation occurs if the foreign person is engaged in the conduct of a U.S. trade or business and has income effectively connected with the trade or business. In these instances, foreign persons compute their U.S. income tax liability similar to U.S. persons; that is, they are allowed to claim deductions attributable to their income and to offset their tax liability with allowable tax credits. Any excise tax or tariff paid by a foreign person engaged in a U.S. trade or business is therefore treated as an item of expense or as includible in costs of goods sold.

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[2] These are the excise tax on investment income of private foundations and the so-called "penalty" excise taxes relating to certain proscribed transactions or expenditures by charitable organizations, private foundations, black lung benefit trusts, pension plans, welfare benefit plans, and real estate investment trusts, and excess "golden parachute" payments.

In determining whether a foreign person is engaged in a trade or business, all the facts and circumstances are taken into account. Selling inventory property into the United States, however, generally is considered engaging in a U.S. trade or business. Generally, only U.S.-source income is considered to be effectively connected with a U.S. trade or business. One category of foreign-source income that is considered effectively connected with a U.S. trade or business, however, includes income derived from the sale of inventory property to the extent the income is attributable to a U.S. office or other fixed place of business within the United States and the sale occurs through such office or other fixed place of business.

In the case of sales of personal property (such as inventory), income derived from such sales generally is U.S.-source if title to the goods passes within the United States. If title passes outside the United States, the income generally is foreign-source and generally is not considered effectively connected with the trade or business, and hence, subject to U.S. tax. Thus, in general, foreign persons can avoid becoming subject to U.S. income tax by passing title offshore.

Revenue effect of imposing excise taxes and tariffs

Federal excise taxes and tariffs are deductible for income tax purposes when incurred in the conduct of a trade or business or for the production of income. Thus, in such cases, the net revenue derived by the Federal Government from imposition of such taxes and tariffs is less than the gross receipts from such taxes or tariffs.

The revenue effect of imposing an excise tax or tariff consists of two parts: (1) the excise tax or tariff receipts, and (2) an offsetting change in income tax receipts. The amount of excise tax or tariff receipts depends on both the excise tax or tariff rates imposed and the reduction in sales of taxable items attributable to imposition of the tax or tariff.

The methodology used by the Joint Committee on Taxation, the Treasury Department, and the Congressionl Budget Office assumes a change in excise or tariff receipts alters estimated income tax receipts. This is necessary to maintain consistency with macroeconomic projections and budget baselines. If projected gross national product (GNP) is fixed at the baseline level and all other things are held equal, an increase in excise tax or tariff receipts reduces national income. The reduction in national income may occur in the industry subject to the excise tax or tariff, if the cost of the tax or tariff is not passed through to consumers. Alternatively, if the excise tax or tariff cost is passed through to consumers, then, consistent with budget baselines, prices of other products fall and other incomes are reduced.

The components of national income include wages and salaries, proprietors' income, rental income of persons, corporate profits, and net interest. To estimate the loss of income tax receipts attributable to a reduction in national income, a weighted average tax rate is computed using estimates of the effective tax rate on each component of national income. Under the Chairman's proposal, the weighted average effective tax rate is estimated to be 22 percent. Thus, the net revenue to the Federal Government from an excise tax or tariff is estimated to be 78 percent of the gross amount. This analysis is illustrated by the following table:

Excise Tax	Present Law Rate	Net Revenue to Government
Distilled Spirits	$12.50/proof gal.	$ 9.75/proof gal.
Cigarettes	$ 0.16/pack	$ 0.125/pack
Gasoline	$ 0.09/gallon	$ 0.072/gallon

Additionally, revenues from many of the Federal excise taxes and certain tariffs are deposited in trust funds for user- or benefit-based spending programs. The amount transferred to such trust funds is equal to gross tax or tariff receipts. Thus, income tax deductions for such excise taxes and tariffs result in a net revenue loss to the general fund of the Treasury.

Overview of the Chairman's Proposal

General rule

Under the Chairman's proposal, Federal excise taxes and tariffs would not be deductible for Federal income tax purposes.

This deduction disallowance rule would apply to all forms of deductibility, whether direct or indirect, and whether otherwise allowable in a single taxable year or over several taxable years. Thus, for example, Federal excise taxes and tariffs would not be deductible as ordinary or necessary business expenses (sec. 162) or as expenses incurred in the production of income (sec. 212), would not be includible in cost of goods sold for purposes of determining gross income from sales of inventory, and would not increase the basis of any asset for purposes of determining allowances for depreciation or gain or loss on disposition.

Under a rule designed to ensure that nondeductibility would have a uniform impact on all taxpayers, the income of persons liable for excise taxes could not be reduced by otherwise allowable deductions below the amount of the payor's total excise tax liability for the year (the "excise tax disallowance amount"). Thus, for example, the taxpayer's excise tax disallowance amount could not be reduced by current losses, net operating loss carryovers or carrybacks from prior or future taxable years, or by losses of affiliated corporations filing a consolidated return with the taxpayer. The maximum tax rate under the Chairman's proposal (35 percent) would apply to the excise tax disallowance amount; the tax as so computed could not be offset by tax credits. A similar rule would apply with respect to tariffs.

Special rules would be provided to in the case of all non-U.S. persons not otherwise subject to the Federal income tax.

Application to pass-through entities

In the case of partnerships, trusts, cooperatives, and other pass-through entities liable for Federal excise taxes or tariffs, the disallowance of the deduction would occur at the partner or beneficiary level. All computations would be performed at the entity level, however. Thus, the entity would be required to withhold and pay over to the Federal Government the income tax liability of its owners or beneficiaries attributable to the nondeductibility rule. Withholding entities would be required to provide beneficial owners with a statement of their allocable share of the excise tax and of the tax liability attributable to such amount.[3]

Incidence of excise taxes and tariffs

In general, the incidence of Federal excise taxes and tariffs would remain on the seller, producer, manufacturer, or importer of taxable products and on the provider of taxable services, with certain clarifications regarding present law.[4] The incidence of the air passenger, air cargo, and telephone excise taxes would be shifted from the consumer of services to the service-provider or seller in order to ensure that the full impact of nondeductibility would be achieved.

Effective date

The nondeductibility rule would apply with respect to excise taxes and tariffs paid or incurred after December 31, 1986.

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[3] The effect of this approach would be the same as if the excise tax and tariff disallowance amount were flowed though to the owners subject to the rules and general limitations described above, and the owners then received a credit against their income tax liability for taxes withheld by the entity.

[4] As under present law, the use without sale by a producer, etc. in its business would be treated as a sale.

III. MODIFICATIONS OF CERTAIN EXCISE TAXES

A. Wine Tax Rate Equivalency

Present Law

Wine.--Wine is taxed at rates that vary according to the alcohol content, as follows:

Type of wine	Tax per gallon
Still wines:	
Not more than 14% alcohol	17 cents
Above 14% but not above 21%	67 cents
Above 21% but not above 24%	$2.25
Artificially carbonated wines	$2.40
Champagne and sparkling wines	$3.40

Most wine sole in the United States falls in the category of not more than 14% alcohol.

Distilled spirits.--Distilled spirits (whiskey, liquor, or liqueurs) are taxed at $12.50 per proof gallon. A proof gallon contains 50-percent alcohol.

Beer.--Beer is taxed at $9 per barrel of 31 gallons; this is equivalent to 29 cents per gallon. The rate is reduced to $7 per barrel on the first 60,000 barrels of beer for producers of who produce no more than two million barrels of beer per year.

Comparative rates.--Per ounce of alcohol, the Federal excise tax rate is 19.5 cents on whiskey or other distilled spirits; 5.0 cents on beer (containing 4.5 percent alcohol); and 1.2 cents on most wine (i.e., for wine containing not more than 14 percent alcohol). Thus, the same volume of alcohol is taxed four times more heavily in distilled spirits than in beer, and 16 times in distilled spirits more heavily than in wine. The same volume of alcohol in beer generally is taxed four times more heavily than in wine.

Chairman's Proposal

Under the Chairman's proposal, the excise tax rate on wine having an alcohol content of 21 percent or less would be increased to a rate equivalent to the alcohol proof rate currently imposed on beer, effective October 1, 1986.

B. Adjusting Excise Taxes on Alcohol, Tobacco, and Motor Fuels for Price Changes

Present Law

Excise taxes on alcohol and tobacco products, on gasoline, diesel fuel, and special motor fuels, and on aviation fuels are imposed at flat rates per quantity each taxable product. Thus, the amount of tax does not change when the price of the taxed product changes. For example, a fifth of whiskey with 40 percent alcohol would be taxed at $2 per gallon, whether the price per gallon was $10 (equivalent to a 20-percent tax) or $20 (equivalent to a 10-percent tax).

Some excise taxes are levied as a specified percentage of the price paid--for example, the eignt-percent tax on the price of an air passenger ticket and the five-percent tax on the cost for transporting air freight. Thus, the amount of tax paid on an air passenger ticket is $4 on a $50 ticket, $8 on a $100 ticket price, and $16 on a $200 ticket.

Chairman's Proposal

The rates of excise tax on alcohol and tobacco products and on motor fuels would be adjusted to reflect increases in prices. The rates, as adjusted, could not fall below the present-law levels or, in the case of wine, the increased level provided in the Chairman's proposal. This provision would be effective October 1, 1986.

APPENDIX A: PRESENT FEDERAL EXCISE TAXES AND RATES, BY INCIDENCE OF TAX[5]

1. Excise Taxes Imposed on Manufacturers (Producers) or Importers

Alcohol Beverage Taxes

Distilled spirits (sec. 5001)	$12.50 per proof gallon
Wines (sec. 5041):	
Still wines--	
Not more than 14% alcohol	17 cents per wine gallon
14-21% alcohol	67 cents per wine gallon
21-24% alcohol[6]	$2.25 per wine gallon
Artificially carbonated wines	$2.40 per wine gallon
Champagne and other sparkling wines	$3.40 per wine gallon
Beer (sec. 5051)	$9 per barrel (31 gal.) generally[7]

Tobacco Products Taxes

Cigars (sec. 5701(a)):	
Small cigars	75 cents per thousand
Large cigars	8-1/2 percent of wholesale price (up to $20 per thousand)

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[5] The private foundation and "penalty" excise taxes (chapters 41-44 and 46 of the Code) are not listed in this Appendix, inasmuch as they are nondeductible under present law. For a complete listing of present-law Federal excise taxes, see Joint Committee on Taxation, Schedule of Present Federal Excise Taxes (As of January 1, 1986), (JCS-6-86), February 27, 1986.

[6] Wines containing more than 24% alcohol are taxed as distilled spirits.

[7] $7 per barrel for certain small brewers.

Cigarettes (sec. 5701(b):	
Small cigarettes	$8 per thousand (i.e., 16 cents per pack of 20)
Large cigarettes	$16.80 per thousand
Cigarette papers and tubes:	
Cigarette papers (sec. 5701(c))	1/2 cent for each 50 papers
Cigarette tubes (sec. 5701(d))	1 cent for each 50 papers
Highway Trust Fund Taxes	
Tires for heavy vehicles (sec. 4071)	Graduated rates for tires over 40 pounds
Gasoline for highway use (sec. 4081)	9 cents per gallon generally[8]
"Superfund" Taxes[9]	
Crude oil (sec. 4611)	0.79 cents per barrel (expired Oct. 1, 1985)
Chemical feedstocks (sec. 4661)	Tax ranged from $0.22 to $4.87 per ton (expired Oct. 1, 1985)
Black Lung Trust Fund Tax	
Coal (sec. 4121)	$1.10 per ton for underground coal and 55 cents per ton for surface coal (up to 4.4 percent of the coal's selling price)

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[8] There is a 6-cents-per-gallon exemption for gasohol and a 4.5-cents-per-gallon exemption for alcohol fuels from natural gas.

[9] Although these Superfund excise taxes expired October 1, 1985, they are listed here because tax extension legislation for these taxes has passed both the House and the Senate (H.R. 2005), and is awaiting conference action.

Aquatic Resources Trust Fund Taxes

Gasoline used in motorboats (sec. 4081)	9 cents per gallon generally[10]
Sport fishing equipment (sec. 4161(a))	10 percent of manufacturers (importers) price; except 3 percent for electric outboard motors and certain fishfinders (tax on fish finders limited to $30 per item)

Bows and Arrows and Firearms Taxes

Bows and arrows (sec. 4161(b))	11 percent of manufacturers (importers) price
Pistols and revolvers (sec. 4181)	10 percent of manufacturers (importers) price
Rifles and shotguns and ammunition (sec. 4181)	11 percent of manufacturers (importers) price
"Nonregular" firearms (secs. 5811, 5821):	
Transfers generally	$200 per transfer
Transfers of certain concealable weapons	$5 per transfer
Making such firearms	$200 per firearm
Gas Guzzler Tax (sec. 4064)	Taxed at graduated levels, if under 22.5 mpg

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[10] See footnote 8.

Crude Oil Windfall Profit Tax
(sec. 4986 *et seq.*)

Tier 1 oil	70 percent of windfall profit; 50 percent for independent producers
Tier 2 oil	60 percent of windfall profit; 30 percent for independent producers
Tier 3 oil:	
Newly discovered oil	22.5 percent for 1984-87; 20 percent for 1988; and 15 percent thereafter
Heavy oil and incremental tertiary oil	30 percent

2. Excise Taxes on Retailers and Service Providers

Highway Trust Fund Taxes

Diesel fuel (sec. 4041(a)) generally[11]	15 cents per gallon
Special motor fuels, including alcohol fuels from petroleum (sec. 4041(b))	9 cents per gallon
Heavy trucks and trailers (sec. 4051)	12 percent of retailers price

Airport and Airway Trust Fund Taxes

Fuels for noncommercial (general) aviation (sec. 4041(c)):	
Gasoline	12 cents per gallon
Nongasoline fuels	14 cents per gallon

Aquatic Resources Trust Fund Taxes

Special fuels used in motorboats (sec. 4041(a)(2))	9 cents per gallon

Wagering Tax (sec. 4401)	2 percent of wager generally, except 0.25 percent in States where wagering authorized by State law

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[11] A net tax of 3 cents per gallon (12 cents per gallon refund or credit) applies to certain privately operated intercity buses.

Tax on Foreign Insurance Policies (sec. 4371)

Casualty insurance and indemnity bonds	4 cents per dollar of premiums
Life insurance, sickness	1 cent per dollar of premiums (unless the insurer is taxed under sec. 813)
Reinsurance	1 cent per dollar of premiums

3. Excise Taxes Imposed on Service Recipients [12]

Airport and Airway Trust Fund Taxes

Domestic air passenger tickets (sec. 4261)	8 percent of airfare
International departures (sec. 4261(c)	$3 per person
Domestic air cargo (sec. 4271)	5 percent of charge

Communications (Telephone) Tax (sec. 4251)	3 percent of amount paid

4. Excise Taxes Imposed on Use

Inland Waterways Trust Fund Tax

Diesel and other liquid fuels used by commercial cargo vessels on specified inland or intracoastal waterways (sec. 4042)	10 cents per gallon

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[12] These excise taxes are collected from the payor (consumer of the service) by the business providing the service and paid over to the Internal Revenue Service; however, the tax liability is on the purchaser.

Highway Trust Fund

Use tax on heavy highway vehicles (sec. 4481)	Graduated tax rates on vehicles over 55,000 pounds

Deep Seabed Trust Fund

Tax on mining of certain hard minerals from the seabed (sec. 4495)	3.75 percent of 20 percent (or 0.75 percent) of fair market value of specified commercially recoverable minerals (manganese, nickel, cobalt, or copper)

5. Occupational Excise Taxes

Alcoholic Beverages

Brewers (sec. 5091)	$110 per year ($55 for less than 500 barrels a year)
Wholesale dealers (sec. 5111):	
Liquors and wines	$255 per year
Beer	$123 per year
Retail dealers (sec. 5121):	
Liquors and wines	$54 per year
Beer	$24 per year

"Non-Regular" Firearms[13]

Importers and manufacturers (sec. 5801)	$500 per year[14]
Dealers (sec. 5801)	$200 per year[15]

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[13] Firearms other than regular pistols, revolvers, rifles and shotguns (e.g., machine guns, sawed-off shotguns or rifles, silencers, explosive devices, and certain concealable weapons).

[14] For importers and manufacturers of concealable weapons only, the annual tax is $25 per place of business (sec. 5845(e)).

[15] For dealers of nonconcealable weapons only, the annual tax is $10 per place of business (sec. 5845(e)).

Wagering (sec. 4411)	$500 per year; except tax is $50 per year in States where wagering is authorized by State law.

APPENDIX B: FEDERAL EXCISE TAX RECEIPTS BY SOURCE, FISCAL YEARS 1985-1987

(in millions of dollars)

Source	1985 Actual	1986 Estimate	1987 Estimate
Federal funds:			
Alcohol taxes:			
Distilled spirits	3,728	4,110	4,104
Beer	1,660	1,605	1,613
Wines	269	276	291
Special taxes in connection with liquor occupations	21	21	21
Refunds	-116	-124	-128
Total alcohol taxes	5,562	5,888	5,901
Tobacco taxes:			
Cigarettes	4,743	3,536	2,320
Proposed legislation[16]	.....	1,021	2,242
Cigars	30	30	30
Cigarette papers and tubes	2	2	2
Other	8	8	8
Refunds	-4	-3	-2
Total tobacco taxes	4,779	4,594	4,600
Manufacturers excise taxes:			
Firearms, shells, and cartridges	89	92	98
Pistols and revolvers	23	24	26
Bows and arrows	8	9	9
Gas guzzler tax	40	58	75
Windfall profit tax	6,396	4,161	2,774
Refunds	-61	-90	-27
Total manufacturers excise taxes	6,496	4,255	2,956

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[16] Permanent extension of 16-cents per pack cigarette tax rate (enacted in P.L. 99-272).

Miscellaneous excise taxes:			
General and toll telephone and teletype service........	2,147	2,327	2,551
Wagering taxes, including occupational taxes..........	7	7	8
Employee pension plans........	14	14	15
Tax on foundations............	142	127	127
Foreign insurance policies....	74	80	87
Other........................	1	....	....
Refunds......................	-65	-20	-20
Total miscellaneous excise taxes............	2,320	2,535	2,768
Undistributed Federal tax deposits and unapplied collections..................	-57	154	8
Total Federal fund excise taxes............	19,097	17,426	16,233
Trust funds:			
Highway:			
Gasoline...................	8,886	8,730	8,846
Trucks, buses, and trailers................	1,397	1,198	1,190
Tires, innertubes, and tread rubber............	224	251	239
Diesel fuel used on highways................	2,559	2,618	2,700
Use-tax on certain vehicles................	379	406	430
Proposed legislation[17].....	....	....	623
Refunds..................	-428	-180	-214
Total highway trust fund...	13,015	13,022	13,814
Airport and airway:			
Transportation of persons..	2,509	2,607	2,882
Waybill tax...............	134	144	154
Tax on fuels..............	104	114	118
International departure tax	108	94	98
Refunds..................	-4	-5	-5

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[17] President's proposed repeal of gasohol and bus excise tax exemptions.

Total airport and airway trust fund..............	2,851	2,954	3,247
Aquatic resources trust fund.	126	203	182
Black lung disability insurance trust fund................	581	546	580
Proposed legislation[18].............		....	203
Inland waterway trust fund.....	40	51	52
Hazardous substances response trust fund................	273	15	....
Proposed legislation[19]............		412	893
Post-closure liability trust fund[20]......................	7	....	....
Total trust fund excise taxes	16,894	17,202	18,970
Total excise taxes	35,992	34,628	35,203

Source: Fiscal 1987 Budget

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[18] President's proposed increase in coal excise tax; a lesser tax rate increase was enacted in P.L. 99-272 (effective on April 1, 1986.

[19] President's prposed extension and increase in "Superfund" excise taxes and repeal of post-closure excise tax. Proposed legislation to extend and revise these excise taxes pending in conference on H.R. 2005.

[20] Ibid.

APPENDIX C: TARIFFS, VALUE AND COLLECTIONS, BY MAJOR CATEGORY, CALENDAR YEAR 1985

	Dutiable Value	Estimated Duties Collected	Average Tariff Rate
Meats	$ 1,648	$ 43	2.6%
Dairy products	398	38	9.5%
Fish	907	45	5.0%
Fruit/vegetables	2,461	347	14.1%
Alcoholic beverages	2,762	127	4.6%
Tobacco	526	64	12.2%
Crude oil	31,354	106	0.3%
Petroleum products	15,596	107	0.7%
Organic chemicals	3,129	269	8.6%
Inorganic chemicals	942	37	3.9%
Pharmaceuticals	754	29	3.8%
Tires	1,728	73	4.2%
Plywood	599	41	6.8%
Paper	1,382	47	3.4%
Textile yarns & fabrics	4,464	494	11.1%
Glass	1,702	192	11.3%
Iron and Steel mill products	9,358	492	5.3%
Non-ferrous metals	3,495	75	2.2%
Metal manufactures, NSPF	4,611	253	5.5%
Power generating machinery	3,789	147	3.9%
Special purpose machinery	5,647	213	3.8%
Metalworking machinery	2,599	119	4.6%
General industrial machinery	7,108	303	4.3%
Office machinery	10,643	443	4.2%
Sound recording and reproducing apparatus	17,474	900	5.2%
Electrical machinery, NSPF	15,744	736	4.7%
Autos, buses, trucks	31,919	1,639	5.1%
Auto parts	4,382	146	3.3%
Apparel	14,610	3,028	20.7%
Footwear	5,695	572	10.1%
Scientific instruments	2,391	186	7.8%
Toys, games	2,221	187	8.4%

Source: Department of the Treasury, U.S. Customs Service

STATEMENT OF SENATOR GEORGE J. MITCHELL
SENATE COMMITTEE ON FINANCE
HEARING ON TAX REFORM PROPOSAL RELATING TO EXCISE TAXES
APRIL 21, 1986

I would like to thank Senator Packwood for calling this hearing to consider provisions in his tax reform proposal that would deny businesses a tax deduction for all excise taxes paid and that would increase and index selective other excise taxes.

I am pleased this hearing has been called because I believe there is some confusion as to exactly what the effect of this proposal will be. This hearing should help us to understand this issue and I look forward to recieving the testimony.

Although there may be some question as to how the excise tax proposals will affect various industries and consumers, I beleive there is little doubt that the overall result will be the same as a direct increase in excise taxes that will regressively fall hardest on those least able to pay.

For that reason I am unalterably opposed to the excise tax provisions in the tax reform bill now before this Committee. They simply have no place in the tax reform debate.

We started this process and it has moved forward as a needed change in our income tax laws to restore fairness to the system by relating tax burdens to the ability to pay.

This proposal would do the exact opposite. It would greatly increase excise taxes that are not based on the ability to pay in order to reduce the federal income tax which is based on ability to pay.

The startling affect this would have on the distribution of the tax burden is illustrated in a recent study prepared by deSeve Economics. The distributional tables originally released with the Chairman's tax reform proposal were based only on changes in the income tax. Those tables show that individuals with incomes below $10,000 would experience a 77% decline in tax burdens. However, with the excise tax increases factored in, the decline in tax burdens is only 13%. Thus, the excise tax provisions take back almost all of the income tax reduction for families with incomes below $10,000. For taxpayers with incomes between $10,000 and $20,000 the supposed 23% tax reduction turns out to be only an 11% reduction after taking into account the excise tax provisions. Overall, the bill would actually impose a tax increase on the lowest income families who are now paying little or no federal income tax.

A similar result occurs with other income classes although the affect is much less as income increases. In fact, the excise tax proposal would have a neglible effect on the overall tax reduction slated for upper income individuals. While the excise tax provisions take back 83% of the tax cut for the lowest income class, taxpayers with incomes over $200,000 experience less than a 7% decline in the amount of their tax reduction.

The unfairness of this proposal should be apparent to us all. It is ironic that this is being proposed as part of a tax bill which purports to reform our federal system of taxation because over the last several decades federal tax policy has evolved away from regressive excise taxes toward greater reliance on income taxes which relate to the ability to pay.

It was just a little over twenty years ago that this Committee reported out legislation designed to make our tax system fairer by relying less on federal excise taxes. The Excise Tax Reduction Act of 1965 reduced and repealed a number of excise taxes with the aim of "improving the fairness of the tax system".

In the 1965 Committee Report the Senate Finance Committee found excise taxes "objectionable in that they are regressive in their impact, absorbing a larger share of the income of low-income persons than of those with higher incomes. This stems from the fact that low-income families find it necessary to spend a higher proportion of their incomes for consumption than those with larger incomes".

Tax policy principles have not changed over the last 20 years. What this Committee found then is equally true today.

Yet, fiscal pressures of the last few years have forced the Reagan Administration and this Committee to increase a number of excise and use taxes. Under this Administration, the federal government has unfortunately begun to rely to a much greater extent on these kinds of taxes. In fact, one of the larger misconceptions of this Administration is that it is opposed to tax increases on the American people. A more accurate characterization is that it is opposed to income tax increases because in almost every year the Administration has requested, and Congress has approved, a host of payroll, excise and use fee increases. For example, in its 1987 budget request, the Administration requested 10 different payroll, excise and user fee tax increases totaling $19 billion over the next three years.

I raise this point because if recent history is any guide, this Committee will include some sort of excise tax increases to make the numbers add up in this bill. Everyone of us has supported such increases in the last 4 years.

If that occurs -- if this Committee cannot approve a bill without including excise tax increases -- we should all read it as a sign of failure, because fundamentally it will not be true tax reform.

There are many other reasons to oppose these provisions for the arbitrary and disproportionate burden it would impose on a narrow range of businesses and for the disturbing principle it introduces into our tax system that a business should not be permitted to take a deduction for a cost of doing business. As so many have pointed out, denying a deduction for a federal tax paid results in a tax being paid on a tax. When we consider all of the artificial deductions and other preferences built into the tax system -- and so far maintained by this strained tax reform effort -- it makes little sense to disallow true costs of doing business.

I do not believe tax reform is the proper forum for considering any increases in excise taxes in whatever form. It is simply unfair to deny a dedcution for a legitimate cost of doing business and to use these type of regressive taxes to fund a reduction in federal income tax rates.

The CHAIRMAN. The hearing will come to order, please.

Today the Finance Committee is holding hearings on the excise tax provisions contained in the tax reform package which I put before the committee. Those provisions include the following: The elimination of the deductibility of Federal excise taxes and tariffs; increasing the wine excise tax rate to an alcohol equivalent rate with beer; and adjusting the taxes for the following products for future price increases: alcohol, tobacco, and motor fuels.

All told, the Joint Tax Committee estimates that these provisions will result in increased revenues of slightly more than $75 billion over 5 years.

Now, I am well aware, and was aware when these provisions were put in the bill, that many would have concerns about them. At the moment it is unclear what course the committee will take with regard to the issue of the excises. But that will wait for another day.

Today we have about 30, maybe 31, witnesses who have expressed a deep interest in these provisions. Given the number of witnesses today—and I expect we will meet morning, afternoon, and into the evening if necessary—I have asked all of the witnesses to keep their presentations to 5 minutes, other than Treasury, because Treasury has to comment on all of the provisions, whereas most of the other witnesses are here to talk about a single provision.

I have even talked to the Senators, and they have agreed to do the same. I am very appreciative of that, because we are going to be here for a long, long day.

We will start with Senator Ford.

Wendell, if you are ready. Senator Eagleton was first on the basis of seniority, but he is not here. He will be here about 11. So, if you are ready, we are ready to start.

STATEMENT OF HON. WENDELL H. FORD, U.S. SENATE, STATE OF KENTUCKY

Senator FORD. Thank you, Mr. Chairman.

Do you have your stopwatch?

The CHAIRMAN. I've got the stopwatch all ready.

Senator FORD. I have worked awfully hard on this; I doubt seriously I can do it, but I am going to try.

I ask unanimous consent, Mr. Chairman, that the full statement that I have filed with the committee be included in the record.

The CHAIRMAN. Without objection. And all statements will be in the record in total.

Senator FORD. Mr. Chairman, I appreciate the opportunity to voice my concerns about the proposal to fund tax reform by eliminating the deductibility of Federal excise taxes. This proposal is nothing short of a tax on a tax. The industries that take in Federal excise tax act as nothing more than a collection agency for the U.S. Treasury. These industries receive no benefit from these funds, and in the case of some industries actually end up financing the cost of the excise tax.

In Kentucky, we pay business to collect the Kentucky sales tax. Those who collect tax are allowed to keep 2 percent per filing for the first thousand dollars of tax collected, and 1¼ percent of the balance. Denying the deductibility of Federal excise taxes will have the same effect as an outright increase in these taxes of approximately 54 percent.

While I applaud the chairman for removing the poorest from the tax rolls, I find it clearly ironic that these very same taxpayers are the ones who will bear the burden of financing reform.

The purpose of the tax reform exercise is to produce a more simple and fair system of taxation; using regressive excise tax to raise the necessary revenue to make such a plan revenue-neutral ensures that reform will be anything but fair, anything but equitable.

This proposal will have a particularly harsh effect upon Kentucky, causing us to bear an unfair burden for national tax reform. Three of the five major excise taxes are levied on Kentucky products: coal, tobacco, and distilled spirits.

Let me give you some specific examples of the effect of the excise tax proposal on Kentucky industries. A 54-percent increase in the coal excise tax will mean that Kentucky coal will have to pay an additional $70 million a year in excise taxes. This would raise the price of our coal, which is already facing stiff competition on the world market.

One of the Fortune 500 companies with operations in Kentucky will go from a current effective tax rate of 47 percent to a rate of 110 percent under this proposal. This would become a net-loss company, forcing the company, in my opinion, to relocate operations overseas.

Nearly 1,700 Kentuckians would lose their jobs under this proposal. This would come at a time when unemployment is over 20 percent in about a fifth of our counties, and more than 12 percent statewide. Kentucky can simply not afford this tax reform proposal.

My State is second only to California in the number of jobs lost from the excise tax proposal. It would incur more than 14 percent, Mr. Chairman, of the total job loss nationwide.

Furthermore, 40 percent of all excise taxes are paid by taxpayers with incomes under $30,000 a year, and 90 percent of Kentucky taxpayers fit into that category.

The argument has been made that the industries affected by excise tax will be unable to pass the loss of the deduction on, and so there will be no regressive effect. Nothing could be further from the truth. Every group that I have visited with on this issue has one unified message, and that is, they cannot absorb the loss of the deduction and will have to pass it on to the consumer.

The committee will be hearing from other witnesses today who will argue in favor of this proposal as a way of using the Tax Code to discourage the consumption of certain products. The only issue here, Mr. Chairman, is who will bear the financial impact of this proposal and who will benefit from it.

Tax reform is a laudable goal, but only if it is achieved fairly. If an alternative source of revenue cannot be found, then I suggest that taxpayers across this Nation, and Kentucky taxpayers in particular, would be better off with no reform at all.

And I made it under the green, Mr. Chairman.

The CHAIRMAN. You even made it under the yellow, Wendell.

I assume you wouldn't be any happier if, instead of eliminating the deduction of the excises, we simply increased the excises.

Senator FORD. Well, Mr. Chairman, I think the administration's proposal will be opposed to not allowing the deductibility. If you want additional taxes, then you have to go to the excise tax.

You have done a severe job to Kentucky, doubling the cigarette tax, increasing the distilled spirits tax, and now, if you remove the deductibility under the coal, then we would increase the cost to the coal operators by 54 percent.

So, if you want to increase taxes, take that straight on, don't come in the back door and cause chaos to the three major industries in my State.

The CHAIRMAN. But you wouldn't be any more enthusiastic if we were to increase those taxes, rather than eliminating the deduction.

Senator FORD. No, Mr. Chairman, I would not. But on the other hand, what you are saying here is that you want to collect it, and then I have to count that as income when I am collecting it for Big Brother. And Big Brother ought to not do that to those who are working for him.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. I have no questions, Mr. Chairman, thank you. I am delighted to have the views of Senator Ford.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Only a comment: We will put Senator Ford down as undecided. [Laughter.]

Senator FORD. On which aspect? [Laughter.]

Senator PRYOR. Just always glad to hear our esteemed colleague.

The CHAIRMAN. Wendell, thank you very much.

Senator FORD. Mr. Chairman, I want to reiterate, since I do have a second left, that you take a profitable company in my State under this proposal and make them a negative company, and I don't think that is in your mind, and I don't think that is in the best interests of industries.

The CHAIRMAN. Thank you very much.

Senator Wilson.

[The prepared written statement of Senator Ford follows:]

TESTIMONY OF SENATOR WENDELL H. FORD
SENATE FINANCE COMMITTEE
APRIL 21, 1986

MR. CHAIRMAN: I very much appreciate the opportunity to appear before the Finance Committee this morning to express my concerns about the excise tax provisions of your tax reform proposal. On behalf of the forty two non-Finance Committee members who joined Senator McConnell and myself in requesting these hearings, I want to thank you for being so accommodating in scheduling this hearing. The excise tax package is the linchpin of your proposal, and I appreciate your willingness to subject it to public scrutiny. I think it indicates your true desire to move tax reform and produce a bill that is palatable to a majority of the Senate.

Let me first join the long list of those who are commending you for your efforts. Like others I appreciate the tremendous task you had and congratulate you on keeping the tax reform movement alive. I must respectfully disagree, however, with the way in which you propose to pay for tax reform -- that is the $75 billion excise tax and tariff package.

Mr. Chairman, this proposal is nothing short of a tax on a tax. The industries that collect federal excise taxes act as nothing more than a collection agent for the United

States Treasury. These industries receive no benefit from these funds, and in the case of some industries, actually end up financing the cost of the excise tax.

The distilled spirits industry, for example, must pay the federal excise tax 27 days before it is collected from the wholesaler. The tobacco industry, by electronic fund transfer, pays the federal government 2-1/2 days before receiving the excise tax. These industries are effectively giving the federal Treasury an interest free loan for that amount of time at a carrying cost to the industry. It is an unfair reward for those who have the "privilege" of collecting taxes for Uncle Sam.

This is the exact opposite of the course we should be setting. We should, at the least, recognize the service that these industries provide to the federal government, and not penalize them by including these excise and tariff revenues in their taxable income. In Kentucky, we pay business to collect the Kentucky sales tax. Those who collect the tax are allowed to keep 2 percent per filing of the first $1000 of tax collected, and 1-1/4 percent of the balance.

Denying the deductibility of federal excise taxes will have the same effect as an outright increase in those taxes of 54 percent. While I applaud the Chairman for removing the poorest from the tax rolls, I find it cruelly ironic that these very same taxpayers are the ones who will bear the burden of financing reform. The stated purpose of the tax reform exercise is to produce a more simple and fair system of taxation. Using excise taxes to raise the necessary revenue to make such a bill revenue neutral ensures that the bill will be anything but fair and equitable.

This proposal will have a particularly harsh effect upon Kentucky, causing us to bear an unfair burden for national tax reform. Three of the five major excise taxes are levied on Kentucky products: coal, tobacco and distilled spirits. Close to 1,700 Kentuckians would lose their jobs under this proposal, and at a time when unemployment is over 20 percent in about a fifth of our counties and over 12 percent statewide. Kentucky can simply not afford this tax reform proposal. Kentucky is second only to California in the number of jobs lost from the excise tax proposal, and represents over 14 percent of the total job losses nationwide.

The effect on Kentucky is particularly harsh when compared to the House-passed bill. The Chairman's plan would eliminate 69 percent of the relief provided under the House bill to Kentucky families making under $11,000 a year. Median income families, those making $25,800 a year, would lose 45 percent of the savings gained in the House-passed bill.

Let me give you some specific examples of the effect of the excise tax proposal on Kentucky industries. A doubling of the coal excise tax will mean that Kentucky coal will have to pay an additional $70 million a year in excise taxes. This follows on the heels of the 10 percent increase in the excise tax enacted just this year, and will seriously impact the competitive price of our coal. The distilled spirits industry would incur an estimated additional tax liability of $370 million per year.

One of the large Kentucky-based gasoline retailers will have a $40 million increase in its tax liability due to the loss of the excise tax deductibility. This exceeds the company's gross income from the retail operation and will have to be passed on to the consumer, resulting in price increases of over 3 cents per gallon on gasoline and 5 cents per gallon on diesel. One of the Fortune 500 companies with operations in Kentucky would go from a current effective tax rate of 47 percent to a rate of 110 percent under this proposal, and would become a net loss company forcing the company to relocate operations overseas.

The argument has been made that the industries affected by excise taxes will be unable to pass the loss of the deduction on, and so there will be no regressive effect. Nothing could be farther from the truth. Every group that I have visited with on this issue has had one unified message, and that is that they cannot absorb the loss of the deduction and will have to pass it on. Clearly, in the case of those industries which will suddenly incur tax liabilties in excess of their gross income, the loss of the deduction will be passed on in full. The loss of the deduction increases the cost of production, and as with any other costs, will be passed on in the price of the goods. There is no doubt that this proposal will have the same effect as an outright increase of up to 54 percent excise taxes.

The original purpose of tax reform was to make the tax laws more simple and fair. I don't think anyone will contend that any of the main proposals are more simple. That leaves the goal of fairness. There is nothing fair, nor equitable, in using regressive excise taxes to lower wealthy corporate and individual tax rates. Tax reform which must be paid for with excise tax revenues is not reform at all. If there are no alternative revenue sources, then I would suggest that we be honest with the American people about what the real purpose of tax reform is -- to give further tax breaks to the rich to be paid for out of the pockets of poor and middle income taxpayers.

The Committee will be hearing from other witnesses today who will argue in favor of this proposal as a way of using the tax code to discourage consumption of certain products. Unfortunately, this argument misses the point. The purpose of tax reform is to make the tax laws more simple and fair. Financing such reform with excise taxes ensures that reform will not be fair. There is no equity in penalizing any group in order to lower the tax rates of the wealthy. The only issue here is who will bear the financial impact of this proposal and who will benefit from it. And the answer to that is that low and middle income taxpayers will finance the huge tax breaks given to the wealthy.

Taxpayers with incomes over $100,000 pay only 6 percent of all excise taxes. Forty percent of all excise taxes are paid by taxpayers with incomes under $30,000 a year, and 90 percent of Kentucky taxpayers fit into that category. Clearly, the impact of this proposal falls hard on the least fortunate and provides significant relief to upper income individuals and corporations at the expense of low and middle income families. Although the tax reform proposal will also provide relief to the low and middle income taxpayer, the relief granted to these groups is seriously eroded by the excise tax plan. And in my State of Kentucky, 90 percent of Kentucky taxpayers would bear the lion's share of financing their own tax break.

The indexing provisions of this proposal are particularly onerous, and have the effect of increasing excise taxes by closer to 80 percent. A study to be released by Chase Econometrics shows the inflationary effect of this provision. As the affected industries lose the ability to deduct excise taxes, they will be forced to pass some, if not all, of this additional cost of doing business on to the consumer. That means higher prices, which then will trigger the indexing of the tax. As the excise tax increases, the industries will again pass a part of the increase on, again triggering the indexing of the tax. And the process continues without end in a vicious, inflationary cycle. Other governments which have used indexing as a means of raising revenues have found that it did not work. In 1981 the Canadian government indexed the federal alcohol excise tax. As a result, alcohol taxes increased five times between April 1981 and September 1984, resulting in a loss of 3,200 Canadian jobs. Due to the disasterous result, indexing was repealed in May 1985.

But there is an equally disturbing issue raised by this proposal. Disallowing the deduction for excise taxes and tariffs means that industry must now include the income that they receive as a collection agent for the government in their total gross income. There is a strong argument to be made that this is an unconstitutional tax on capital, as opposed to income, under the Sixteenth Amendment. Federal excise taxes and tariffs have long been recognized as a cost of the goods sold. In order to determine gross income, to be taxed under the Sixteenth Amendment, cost of goods sold must be deducted from gross receipts. The current deduction appropriately subtracts the capital cost of the excise tax and tariffs from gross receipts. Disallowing the deduction will improperly subject that income, properly classified as capital, to the income tax.

Tax reform is a laudable goal, but only if it is achieved fairly. One sector of our economy should not be penalized so to provide benefits to another. Nor should one group of taxpayers benefit at the expense of another. Unfortunately, this is exactly the result under the Chairman's proposal. Denying the deductibility of excise taxes will cause these taxes to be raised by 54 percent. Indexing current excise taxes will only begin a spiral of inflationary increases, requiring the poorest in this country to bear a greater and greater share of tax reform.

Tax reform which must be accomplished by increasing the burden of regressive excise taxation on lower and middle income taxpayers is not reform at all. If an alternative source of revenue cannot be found, then I would suggest that taxpayers across this nation, and Kentucky taxpayers in particular, would be better off with no reform at all.

STATEMENT OF HON. PETE V. WILSON, U.S. SENATE, STATE OF CALIFORNIA

Senator WILSON. Thank you, Mr. Chairman.

I am grateful to you and the members of this committee for conducting this hearing this morning. I will submit my testimony, and at your invitation, attempt to summarize it.

There are three problems in the tax reform proposal that affect a single industry about which I will be talking this morning, the winemaking and grapegrowing industry.

The first proposed change would disallow deductibility of excise taxes. This, I am informed by the U.S. Treasury, would have the effect of raising the per gallon cost of wine by 73 cents.

The second proposed change would adjust the excise tax on tobacco, motor fuel, and alcohol, including wine, to reflect future price increases. Of the $6.2 billion that this is expected to raise over the next 5 years, $500 million would result from increased wine excise tax revenues.

Now, those two changes obviously affect a number of other industries, in addition to wine, but the final proposed change that I will discuss this morning is industry-specific.

In the attempt to generate additional Federal revenues, the tax reform proposal contains an astonishing fourfold increase in the Federal excise tax on wine. On this point it is critical that each member of the tax-writing committee not be misled by the language used to describe this staggering 400-percent excise tax increase.

Presumably it is to achieve equivalency. While the present excise tax on 1 gallon of wine is 17 cents, that on 1 gallon of beer is 29 cents. In order to achieve what is presumably equivalency, there would be an increase on the wine per gallon tax of 87 cents. That is a 400-percent increase, Mr. Chairman, and not equivalent to 29 cents per gallon.

Recently, the Joint Economic Committee held hearings on this very subject. What was determined was that most of these wineries all across the United States—in your home State, in mine, in Texas, Arkansas, New York, and in a number of other States that were represented there—are small mom-and-pop operations. These are literally family-run wineries, and they are very small wineries. With the exception of the 15 largest, there are more than 900 small wineries competing for about 10 percent of the U.S. domestic sales.

Now, Mr. Chairman, they cannot afford a 400-percent increase. And as Senator Ford said in speaking of the industry in his State, they have no choice, these small operations, but to pass it on to the consumer. Their choice is to go out of business.

Hard times have already come to grape growers and wine producers, before they have ever heard of the tax reform proposal. They have experienced plummeting land values, plummeting collateral for their operating loans, and a serious economic decline. They are confronting a situation in which they are already in trouble. And this would be not just the last straw; it would be more than a straw, it would be a 2 by 4 that would in fact have the effect of putting many of these small concerns out of business.

Since 1982, prices in some wine-grape-growing regions of California have dropped from $140 per ton to $95 per ton, which does not even cover the cost of production.

Nearly 57,000 acres of California vinyards were either abandoned or not harvested last year.

I asked the Department of Agriculture 3 weeks ago to analyze the effect which this tax proposal would have on this segment of American agriculture—which, by the way, does not receive any Federal subsidies or price supports. Unfortunately, the Department of Agriculture officials indicated that it would be premature to release their economic analysis prior to today's hearing.

So, this morning, by letter to the Secretary of Agriculture, I have renewed my request for this information, and upon receipt of it I intend to include it as part of the record of the Joint Economic Committee hearing, and, Mr. Chairman, with your permission, would ask that it be included along with the analysis of the Treasury Department in today's hearing record.

The CHAIRMAN. Without objection.

[The information follows:]

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

April 29, 1986

Honorable Pete Wilson
United States Senate
Washington, D.C. 20510

Dear Senator Wilson:

Thank you for your recent letter requesting Department analysis of the impact of the Senate Finance Committee's Tax Reform Bill on the grape and wine industry.

The bill contains three provisions that would affect the industry. It calls for:

- Elimination of excise tax deductibility for Federal income tax purposes;
- Indexing of excise taxes on alcohol, tobacco, and fuel; and
- An increase in the excise tax on wine to make it equivalent to the excise tax on beer on a per unit of alcohol basis.

The first two provisions would affect the grape and wine industries along with all other industries subject to Federal excise taxes. Their impact would be possibly more significant than the impact of excise tax equalization, but neither provision would impose any unique burden on the industry.

The third provision, however, would put a special burden on the grape and wine industry. Under current law, wine containing less than 21 percent alcohol is subject to a tax of approximately $5.50 per barrel. This rate is substantially lower than the rate for beer, particularly if the two are compared on an alcohol content basis. The differences in rates has traditionally been justified in part on the basis of industry claims that wine is used as more than an alcoholic beverage. Assuming beer is 4 percent alcohol, the typical beer tax of $31 per barrel is the equivalent of a tax of 7.25 percent per 1 percent of alcohol per gallon. The typical table wine with a 12 percent alcohol content is taxed at less than 1.5 percent per 1 percent of alcohol per gallon. The Senate Finance Committee's proposal raises the tax rate on wine to equal the rate on beer. This would increase the tax on table wine, the category most seriously affected, from 15-20 cents to 85-90 cents a bottle. This is the equivalent of a 10 percent increase in retail prices.

While it is difficult to forecast how much of the added tax would be passed backward to producers or forward to consumers, the adjustments involved in either case are significant enough to raise serious questions. If the tax increase were passed back to winery and vineyard operators, it would add to pressure on an industry faced with serious excess capacity problems. If passed forward to consumers, the tax would reduce demand for wine enough to force the industry to scale back. Given the industry's links to other sectors of the economy, a scale-back could cost the economy as a whole more than the likely increase in revenue.

If all of the added tax in question was passed back to producers, it would be the equivalent of $115 per ton of grapes or two-thirds of the price received by growers over the last several years. Clearly, all of the tax could not be passed back to producers despite supply and demand elasticities that suggest growers would normally absorb all or most of the adjustment.

If part or all of the added excise tax were passed on to consumers, the impact on the industry would be somewhat less, but the tax would reduce economic activity outside the sector more than enough to offset any lessening of pressure on the grape and wine industry. A 10 percent increase in the retail price of wine would reduce wine demand 5-6 percent. Assuming such a reduction was spread evenly between domestic and imported wines, U.S. wineries would loose up to 24 million gallons of demand and vineyards would loose a market for 150,000 tons of grapes. This industry loss would affect activity well beyond the sector. Industry economists estimate employment in grape and winery operations at more than 200,000 and suggest that every dollar in activity at the vineyard level ultimately generates another $1.86 in activity while $1 at the winery level ultimately generates another $2.20 in activity.

Given these linkages, the loss of 150,000 tons in grape sales would translate into a $90-million decline in grape sales and related activity up to the vineyard level. The tax would also reduce sales at the winery level $175 million; a loss in winery activity of this magnitude would reduce overall activity in the economy $560 million. Hence, losses at the vineyard and winery levels combined with associated losses elsewhere in the economy could total $650 million.

While the industry data used to generate these impact estimates may overstate vineyard and winery linkages to the rest of the economy, their estimates are comparable to estimates made in university and government circles. The $650 million loss likely if the equalization provision were passed compares with added excise tax revenues of possibly $350 million. The industry's total tax burden with the new provision in place would increase to more than $650 million.

I hope this information is helpful.

Sincerely,

Robert L Thompson

ROBERT L. THOMPSON
Assistant Secretary
for Economics

Senator WILSON. Mr. Chairman, I think the point simply stated is that the three excise tax increases that you are considering would project severe and I think literally devastating tax consequences for this small industry.

The amount of revenue that they produce, in terms of the overall needs that the committee is required to find in order to finance tax reform, will be if not negligible, at least very small. The fact is, while small, they are going to produce a devastating effect, and it will mean that what is a growth industry consisting of a number of small but potentially large and growing concerns able to give employment on an expanding basis may no longer exist. They will simply cease to produce, because it will be unprofitable for them to do so. They will no longer be competitive.

I have not even mentioned the effect of the competition of imports that are heavily subsidized.

Mr. Chairman, I will conclude by pointing out that many years ago Thomas Jefferson urged that the duty on wines, on cheap wines, and that is what we are talking about—most of the wines that we are talking about in fact are under $3 for 750 milliliters. What he said was that we will "achieve sobriety, achieve health, and that we should not make the mistake of driving people to strong drink." [Laughter.]

Now, having listened to my friend from Kentucky, I have no argument with strong drink; I even use it occasionally for medicinal purposes myself. But I think Thomas Jefferson had a point. I hope it will not be lost on the committee.

The CHAIRMAN. Let me ask you a quick question: In order to do what the President asked us to do, the $2,000 exemption, 35-percent personal and corporate rates, and a vastly improved depreciation schedule over the House bill, the committee needs, someplace over 5 years, between, as best we can estimate it, $90 to $110 billion. Where should we get it?

Senator WILSON. Mr. Chairman, I think you have come to the point where you have to ask yourselves whether or not it is worth it. The reform that you are seeking is in many ways commendable, but the economic dislocation that results from virtually every scheme that has been proposed—that in the House, that in the President's initial version, and that which is being considered by your committee—gives rise to an inference that perhaps the reforms are not worth what they would produce in the way of economic dislocation.

I don't say that lightly. I know of the time and the effort that have gone into what you are proposing. I think we have to be very much concerned with whether or not the kind of economic growth that will itself, in time, generate a substantial increase of revenues is not going to be substantially offset by the very thing that is being proposed.

We are talking about an increase in economic growth that has flowed from the reduction in inflation, and that I think is attributable, certainly in part, to Gramm-Rudman, and the expectation of many that we are now serious about cutting back on expenditures. That is another area wholly apart from tax reform that has stimulated economic growth in the name of achieving equity. And I certainly don't hold any brief that the current code is a model of equity. But I would have to say that the best thing we could do for economic growth and steady incremental growth in revenues may be to say that reform of the kind that is being proposed may not be worth the effort. Indeed, not holding any brief that this current code is a model of equity, I will tell you that, perhaps as a minority of one, it seems to me that the greatest tax reform we might hold forth for economic growth is a binding declaration that we will not engage in any tinkering with the code for the next 5 years.

That is not a view that is widely held in this committee, I think; but you have asked the question, and I think that you ought to give that serious consideration.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. I want to thank our distinguished colleague for his contributions here. As always, he has given a lot of thought to his remarks and hasn't tailored his views to those of others. He has come out with his own concept of how we should proceed, and I think that is very helpful. Thank you.

Senator WILSON. Thank you, Senator.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. I have no questions.

The CHAIRMAN. Pete, thank you very much.

Senator WILSON. Thank you very much, Mr. Chairman.

The CHAIRMAN. Has Senator McConnell arrived?

[No response.]

The CHAIRMAN. If not, let us move on to our first panel: J. Tylee Wilson, T. Carlton Blalock, Matthew Myers, and Gerry Oster.

Senator PRYOR. Are we going to hear from Secretary Mentz?

The CHAIRMAN. Oh, I'm sorry. Yes.

Mr. Secretary, we did overlook somebody, didn't we? [Laughter.] I apologize. We will take Secretary Mentz first.

Mr. MENTZ. That is all right; you can move on if you want to.

The CHAIRMAN. And while I indicated, Mr. Secretary, that you would not be held to the 5 minutes because you have to cover everything, I would trust you are not going to read in total your single-spaced 21-page statement.

Mr. MENTZ. That is right. I have one-half a page that I am going to delete. [Laughter.]

The CHAIRMAN. Go right ahead.

[The written prepared statement of Senator Wilson follows:]

STATEMENT BY SENATOR PETE WILSON

GOOD MORNING, MR. CHAIRMAN. I APPRECIATE THE OPPORTUNTITY TO TESTIFY BEFORE THE COMMITTEE AND WISH TO COMMEND YOU AND YOUR COLLEAGUES FOR SCHEDULING THIS HEARING TO ASSESS THE IMPACT WHICH THE REVENUE RAISING PROVISIONS OF THE TAX REFORM PROPOSAL WILL HAVE UPON THE AFFECTED INDUSTRIES. AND JUDGING FROM THE LENGTH OF TODAY'S WITNESS LIST, THOSE THREE EXCISE TAX PROVISIONS AFFECT A LOT OF INDUSTRIES.

WHILE MY TESTIMONY WILL FOCUS UPON JUST ONE--SPECIFICALLY, THE DOMESTIC WINEMAKING AND WINEGRAPE GROWING INDUSTRY--I WILL NEED TO DISCUSS EACH OF THE THREE PROPOSED EXCISE TAX CHANGES. THIS IS NECESSARY BECAUSE EACH CHANGE WOULD IMPOSE AN ECONOMIC COST AND INCREASE THE TAX BURDEN UPON OUR AMERICAN VINTNERS AND GRAPE GROWERS. UNLIKE EVERY OTHER INDUSTRY FROM WHOM YOU WILL HEAR, TODAY, ONLY AMERICAN WINES HAVE BEEN SINGLED-OUT FOR WHAT THOSE AMOUNG US FOLLOWING THE CURRENT STANLEY CUP PLAYOFFS MIGHT DESCRIBE AS A TAX WRITING "HAT TRICK."

AS EACH MEMBER OF THE COMMITTEE KNOWS, THE FIRST PROPOSED CHANGE WOULD DISALLOW THE DEDUCTIBILITY OF EXCISE TAXES AND TARIFFS. ACCORDING TO INFORMATION WHICH I HAVE RECEIVED FROM THE TREASURY DEPARTMENT, THIS PROVISION WOULD RAISE $67 BILLION BETWEEN FISCAL YEARS 1986-1991; OF WHICH $1.2 BILLION IS ATTRIBUTABLE TO THE DISALLOWANCE OF THE DEDUCTION FOR WINE EXCISE TAXES. ACCORDING TO THE WINE INDUSTRY, THIS WOULD HAVE THE EFFECT OF RAISING THE PER GALLON COST OF WINE BY 73 CENTS.

THE SECOND PROPOSED CHANGE WOULD ADJUST THE EXCISE TAX ON TOBACCO, MOTOR FUEL AND ALCOHOL, INCLUDING WINE, TO REFLECT FUTURE PRICE INCREASES. ACCORDING TO THE TREASURY DEPARTMENT, THIS CHANGE WILL GENERATE $6.2 BILLION OVER THE NEXT FIVE YEARS, WITH $500 MILLION RESULTING FROM INCREASED WINE EXCISE TAX REVENUES.

WHILE THESE TWO CHANGES WOULD OBVIOUSLY IMPOSE A SIGNIFICANT COST UPON THE WINE INDUSTRY, IF ADOPTED, THEY WOULD ALSO INCREASE THE TAXES OF SEVERAL OTHER INDUSTRIES THROUGHOUT OUR ECONOMY. THE FINAL PROPOSED CHANGE IS INDUSTRY SPECIFIC, HOWEVER, AND ATTEMPTS TO GENERATE ADDITIONAL FEDERAL REVENUES THROUGH AN ASTONISHING FOUR-FOLD INCREASE IN THE FEDERAL EXCISE TAX ON WINE.

ON THIS POINT, IT IS CRITICAL THAT EACH MEMBER OF THIS TAX-WRITING COMMITTEE NOT BE MISLED BY THE LANGUAGE USED TO DESCRIBE THIS 400% EXCISE TAX INCREASE. WHILE THE TAX REFORM PROPOSAL STATES THAT THE RESULT WILL BE A WINE TAX WHICH IS "EQUIVALENT" TO THE RATE PRESENTLY IMPOSED ON BEER, THE RESULT IS STRIKINGLY DIFFERENT. THE PRESENT EXCISE TAX RATE ON A GALLON OF BEER IS 29 CENTS. THE PROPOSED NEW TAX ON A GALLON OF TABLE WINE WOULD BE 87 CENTS--THREE TIMES HIGHER THAN THE BEER TAX. FOR THE RECORD, THERE IS NOTHING "EQUIVALENT" IN THE PER GALLON AMOUNT OF TAX PAID ON BEER AND ON WINE.

TOGETHER, THE THREE PROPOSALS IN THE TAX PACKAGE BEFORE THE COMMITTEE ARE ESTIMATED TO RAISE $75 BILLION OVER FIVE YEARS. OF THIS AMOUNT, THE AMERICAN WINE INDUSTRY WILL BE CONTRIBUTING $3.5 BILLION. UNDER EXISTING EXCISE TAXES AND TARIFFS, WINE SALES AND IMPORTS GENERATE $295 MILLION ANNUALLY. NEXT YEAR, IF THIS TAX BILL WERE ENACTED, THESE REVENUES WOULD REACH $1 BILLION--MORE THAN A THREEFOLD INCREASE, WHICH, IN MY VIEW, WOULD HAVE A DEVASTATING IMPACT UPON OUR NATION'S WINE PRODUCERS AND WINE GRAPE GROWERS.

IN ORDER TO HELP ME UNDERSTAND THE EFFECT WHICH THESE TAX CHANGES WOULD HAVE UPON THIS INDUSTRY, I CHAIRED A HEARING OF THE JOINT ECONOMIC COMMITTEE TWO WEEKS AGO AND HEARD THE TESTIMONY OF MANY WINEMAKERS AND GRAPE GROWERS FROM THROUGHOUT THE COUNTRY. AS TO BE EXPECTED, WITNESSES CAME FROM THE MANY STATES LONG KNOWN FOR WINE PRODUCTION, INCLUDING SENATOR MOYNIHAN'S STATE OF NEW YORK AND THE CHAIRMAN'S STATE OF OREGON. THERE WAS EVEN A CALIFORNIAN WITNESS OR TWO. BUT THE COMMITTEE ALSO RECEIVED TESTIMONY FROM FAMILY-RUN WINERIES IN ARKANSAS, INDIANA AND OHIO. ADDITIONALLY, FARMERS WHO PART OF DEVELOPING WINEGRAPE GROWING BUSINESSES IN PENNSYLVANIA AND TEXAS APPEARED BEFORE THE JEC.

IT BECAME CLEAR TO ME DURING THE HEARING THAT, FOR THE MOST PART, THIS INDUSTRY IS STILL IN ITS INFANCY. IN MANY REGIONS ACROSS THE NATION, WINE GRAPES ARE BEING GROWN AND WINERIES ARE EMERGING AS NEW, PRIMARILY FAMILY OWNED, SMALL BUSINESSES IN 34 STATES. COLLECTIVELY, THESE DOMESTIC WINE PRODUCERS ACCOUNT FOR NEARLY 70% OF THE U.S. WINE SALES, WHILE IMPORTED WINES COMPRISE THE REMAINING 30% OF THE DOMESTIC MARKET.

THE ECONOMIC VITALITY OF OUR NATION'S WINE INDUSTRY IS OF PARTICULAR IMPORTANCE TO ME--AND NOT JUST BECAUSE I SERVE AS CHAIRMAN OF THE SENATE WINE CAUCUS. IN CALIFORNIA, THERE ARE MORE THAN 500 WINERIES ACCOUNTING FOR SIXTY-FIVE PERCENT OF OUR NATION'S WINE SALES. THE FIFTEEN LARGEST OF THESE PRODUCERS GENERATE 92 PERCENT OF CALIFORNIA'S TOTAL WINE SALES. THIS MEANS THAT THERE ARE ABOUT 485 CALIFORNIA VINYARDS COMPETING FOR THE REMAINING 8% OF THE CALIFORNIA SHARE OF DOMESTIC WINE SALES IN THE UNITED STATES.

ACROSS THE NATION, THERE ARE OVER 400 OTHER WINERIES COMPETING FOR THE REMAINING 5 PERCENT OF THE U.S. MARKET. IN MY VIEW, IT IS THESE VINTNERS, ALONG WITH THE VAST MAJORITY OF CALIFONIA PRODUCERS, WHO WILL BE IMMEDIATELY AND PERHAPS PERMANENTLY INJURED BY THE PROPOSED EXCISE TAX INCREASE.

MOREOVER, THE JEC HEARING MADE IT CLEAR TO ME THAT NOT ONLY THE WINERIES THAT WILL BE HARMED BY THE TAX REFORM BILL. OUR NATION'S WINE GRAPE GROWERS WILL FEEL THE EXCISE TAX "BITE", TOO. UNFORTUNATELY, THE PROPOSED TAX INCREASE COMES IN THE WAKE OF A NUMBER OF YEARS IN WHICH THE GROWERS HAVE LOST MONEY. SINCE 1982, PRICES IN SOME WINEGRAPE GROWING REGIONS OF CALIFORNIA HAVE DROPPED FROM $140 PER TON TO $95 PER TON, WHICH DOES NOT EVEN COVER THE COST OF PRODUCTION. FOR THAT REASON, NEARLY 57,000 ACRES OF CALIFORNIA VINEYARDS WERE EITHER ABANDONED OR NOT HARVESTED LAST YEAR.

THREE WEEKS AGO, I ASKED THE DEPARTMENT OF AGRICULTURE TO ANALYZE THE EFFECT WHICH THIS TAX PROPOSAL WOULD HAVE UPON THIS SEGMENT OF AMERICAN AGRICULTURE WHICH, BY THE WAY, DOES NOT RECEIVE FEDERAL SUBSIDIES OR PRICE SUPPORTS. UNFORTUNATELY, USDA OFFICIALS INDICATED THAT IT WOULD BE PREMATURE TO RELEASE THEIR ECONOMIC ANALYSIS PRIOR TO TODAY'S HEARING. SO THIS MORNING, BY LETTER TO THE SECRETARY OF AGRICULTURE, I HAVE RENEWED MY REQUEST FOR THIS INFORMATION. UPON RECEIPT OF IT, I INTEND TO INCLUDE IT AS PART OF THE RECORD OF THE JEC HEARING AND, MR. CHAIRMAN, WOULD ASK THAT IT BE INCLUDED, ALONG WITH THE ANALYSIS OF THE TREASURY DEPARTMENT, IN TODAY'S HEARING RECORD.

THE JEC HEARING CLEARLY INDICATED TO ME THAT THE CONSEQUENCES OF THIS TAX REFORM PROPOSAL WILL BE LESS INCOME FOR AMERICA'S WINE PRODUCERS AND GRAPE GROWERS AND MARKEDLY HIGHER WINE PRICES FOR AMERICAN CONSUMERS. SOME SUPPORTERS OF THIS EXCISE TAX INCREASE MAY ATTEMPT TO MINIMIZE ITS ADVERSE AFFECT BY SUGGESTING THAT ONLY A SMALL, ELITE AND WELL-TO-DO SEGMENT OF OUR SOCIETY CONSUMES WINE AND THAT THIS UPPER CLASS CONSTITUENCY WITH EXPENSIVE TASTES CAN AFFORD A HIGHER FEDERAL EXCISE TAX. SUCH AN ANALYSIS BESPEAKS A GROSS MISUNDERSTANDING OF THE WINE INDUSTRY.

According to the Bureau of Census, 60 percent of wine sold in America are the inexpensive "jug" wine varieties. The California wine industry estimates that nearly 90 percent of my state's production results in wine priced at less than $3 per bottle (750 ml) and is consumed by 35% of our population on a regular basis. Given this data, an increase in the wine excise tax would penalize a large number of Americans of varying income levels.

In conclusion, I believe that the proposed 400% increase in the wine excise tax is both unfair and regressive and, if enacted, would have a seriously adverse impact on the U. S. wine industry--an industry which has already been plagued with steadily declining market share, lower economic returns and plummeting land values.

Mr. Chairman, I can appreciate the need to bring greater fairness and equity to our tax system and commend your efforts and the work of this Committee; however, no matter how worthy and historic the goal, the means currently under consideration would severely penalize our domestic wine industry while generating less than 3% of the federal revenues necessary to finance the tax reform package. In my view, the potential threat to an entire industry far outweighs the relatively small amount of revenues which this proposal would generate.

For these reasons, I would urge the Committee not to increase the federal excise tax on wine. Thank you.

EXPLANATION OF 16 CENTS PER PACK EXCISE TAX PAID ON CIGARETTES VERSUS AN ALLEDGED LOWER AMOUNT RECEIVED BY THE U.S. GOVERNMENT

We have a 16 cents per pack excise tax on cigarettes. It is alledged that the U.S. government collects less than that amount per pack. This allegation has no basis in fact. Tobacco companies pay 16 cents per pack excise tax on cigarettes. It is true that we treat the excise tax as a deduction in determining our federal income tax. However, this deduction merely acknowledges that excise taxes are a cost of doing business no less than any other cost, and that the federal income tax, as mandated by the Constitution, must tax only net income, not gross revenues. You must remember that, because of the 16 cents excise tax imposition, we must try to price our product to produce a profit, taking this excise tax cost, as well as all other costs, into account. The increased price is itself subject to the federal income tax. To impose a tax on income which is created only because of the excise tax imposition would be manifestly unfair. The present law allowing deduction of excise taxes merely acknowledges this inequity which the absence of this deduction would create.

EXAMPLE A

Assuming there were no federal excise tax (FET):

Selling Price (assuming no FET)	$1.00/pack
Cost of Sales	.80/pack
Net Income	.20/pack
	x 46% rate
Income Tax	$.092/pack

EXAMPLE B

But, because there is an federal excise tax

Selling price ($.16 FET)	$1.16/pack
Cost of Sales	.80/pack
FET	.16/pack
Net Income	.20/pack
	x 46% rate
Income Tax	$.092/pack

EXPLANATION OF 16 CENTS PER PACK EXCISE TAX PAID ON CIGARETTES VERSUS AN ALLEDGED LOWER AMOUNT RECEIVED BY THE U.S. GOVERNMENT

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Net Income	.20/pack x 46% rate
Income Tax	$.092/pack

STATEMENT OF HON. J. ROGER MENTZ, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. MENTZ. Thank you very much, Mr. Chairman.

It is my pleasure to have the opportunity to discuss with you this morning the Treasury Department's views regarding the proposals in your tax reform markup document relating to Federal excise taxes and tariffs.

The proposals would make Federal excise taxes and tariffs nondeductible for Federal income tax purposes, would increase the rate of Federal excise tax on certain wines to the rate currently applicable to beer, and adjust the rates of Federal excise tax on alcohol and tobacco products and certain fuels to reflect future price increases.

The achievement of fundamental tax reform is a central goal of this administration. In the President's view, the key elements of a revenue-neutral tax reform bill are a full $2,000 exemption for itemizers and nonitemizers, at least for individuals in lower and middle income tax brackets; a rate structure with a maximum rate no higher than 35 percent; tax brackets that reduce taxes for middle-income working Americans; basic tax incentives for American industries, including those which depend on heavy capital investment in equipment and machinery; and a minimum tax which allows no individual or business to escape paying a fair share of the overall burden. The President believes that these changes will promote future economic growth, improve fairness, and simplify the system for millions of individual taxpayers.

As the tax reform process has moved forward, the administration, the Ways and Means Committee, and now the Senate Finance Committee, have come to recognize the difficulty of raising enough revenue from the income tax system to accomplish fundamental changes. The administration's tax reform proposal did not include provisions comparable to those in the chairman's plan relating to excise taxes and tariffs; instead, we proposed general basebroadening to maintain the revenue neutrality of our tax reform plan. We encourage renewed consideration of those tax reform proposals made by the administration and not incorporated in the chairman's plan that would raise additional revenues. In addition, we support efforts by the committee to develop alternative revenue-raising proposals that are consistent with the President's tax reform goals. If, however, the base broadening and other revenue-raising proposals that are accepted by the committee do not raise sufficient revenue, we would support raising revenue through excise tax changes, in the context of revenue-neutral tax reform that meets the President's goals. And it is in that spirit, Mr. Chairman, that we consider the excise tax and tariff proposals that are included in your plan.

I will move ahead to the most significant issue, the proposal to deny deductibility of Federal excise taxes and tariffs.

Under current law, Federal excise taxes and tariffs are imposed on a wide range of goods, services, and activities. For fiscal year 1986, excise tax receipts are estimated to be over $34 billion.

During calendar year 1985, total tariff collections were approximately $11.5 billion.

A brief description of the excise taxes and tariffs that generate most of this revenue may be helpful, starting with distilled spirits. The Federal excise tax on distilled spirits is imposed on the producer or importer at the rate of $12.50 per proof gallon. This rate was increased in October 1985 from $10.50 per proof gallon. That means, for example, 1 gallon of 80 proof distilled spirits is equal to 0.8 proof gallons and therefore is subject to a Federal excise tax of $10. The distilled spirits excise tax is expected to generate receipts of $4 billion in fiscal year 1986, and its revenues go into the general fund.

With respect to wine, the rate of tax on wine varies depending upon the alcohol content and carbonation of the wine; 17 cents per gallon is the tax on still wine containing not more than 14 percent alcohol, 67 cents per gallon still wines containing more than 14 percent but less than 21 percent alcohol, $2.25 per gallon on still wines containing more than 21 percent and less than 24 percent alcohol, $2.40 on artificially carbonated wines, and $3.40 per gallon on champagne. Wine excise tax receipts are expected to be $276 million in fiscal year 1986.

On beer, the Federal excise tax is 29 cents per gallon and does not vary based on alcohol content. Beer excise tax receipts are expected to be $1.6 billion in fiscal year 1986.

On tobacco products, Federal excise tax on cigarettes is approximately 16 cents per pack of 20. Excise tax receipts on tobacco products are expected to be $4.6 billion in fiscal year 1986. Those revenues also go into the general fund.

The Federal excise tax on gasoline is presently imposed at the rate of 9 cents per gallon. That tax is expected to yield $8.6 billion in fiscal year 1986, and goes primarily into the highway trust fund.

Similarly, the diesel fuel tax is 15 cents per gallon. That rate was increased in August of 1984 from 9 cents per gallon. I might note it was increased right after I bought my diesel automobile. Receipts from the diesel fuel excise tax are expected to be $2.6 billion. That also goes into the highway trust fund.

That is a review of some of the most significant excise taxes. I am going to skip over the testimony that describes some of the others.

Tariffs are imposed on the importer of the product and are payable when the product enters the customs territory of the United States. During 1984 the total Federal tariff collections were equal to 3.7 percent of the value of all goods imported into the United States. With respect to goods on which tariffs were imposed, the average rate was 5.5 percent.

Turning to the chairman's proposal, the chairman's plan would disallow any deduction or other reduction of income for Federal income tax purposes for the payment of any Federal excise tax or tariff. Thus, the amount of any Federal excise tax or tariff would not be deducted as an ordinary business expense or an expense incurred for the production of income and could not be offset against income from the sale of property as a cost of goods sold, or added to the adjusted basis of depreciable property.

The proposal also includes an antiavoidance rule that would ensure that the deduction disallowance would have the effect of increasing the income tax liability of the payor of the excise tax or tariff by the amount of tax or tariff multiplied by the maximum corporate income tax rate. For example, if the legal incidence of excise tax falls on a corporation with a net operating loss, or an individual taxed at a marginal rate of less than 35 percent, nevertheless the corporation or individual would be treated as having separate-basket income which would be taxed at the maximum rate of 35 percent and could not be offset by any net operating loss or credits.

Preliminarily, our estimate is that the chairman's proposal in this regard would raise $66.5 billion. And as indicated in the table which is a part of my testimony, $9 billion would come from alcohol, $7.5 billion from tobacco, and approximately $20.5 billion from motor fuels.

Although the denial of a deduction would in form affect only Federal income tax liabilities, we believe that the proposal is similar in effect to, and thus is appropriately analyzed as, a direct increase in Federal excise taxes and tariffs. As with a direct increase in these levies, the additional tax burden resulting from the proposal would vary directly with the number of units sold subject to the tax. For example, as under the existing cigarette excise tax, domestic sales of cigarettes by a cigarette manufacturer would generate tax liabilities directly proportional to the number of cigarettes sold, as distinguished from liabilities under the income tax which are not based on units sold but rather on the return to equity capital used in the production of the particular goods.

While there may be some variance depending upon the payor's marginal tax rate, a taxpayer that is in the maximum bracket of 35 percent would have the equivalent of a 54-percent excise tax increase that would be attributable to the nondeductibility of excise taxes. The mathematics of that, Mr. Chairman, are worked out in a footnote to my testimony. For taxpayers in a bracket that is less than 35, of course, the effective increase is somewhat smaller.

The economic effects, I think, are a subject of a great deal of importance, and let me spend just a moment or two on them.

The ability of sellers to shift the tax burden under the proposal to purchasers depends upon the responsiveness of purchasers and sellers of the taxed goods to changes in price. If purchasers are relatively unresponsive to such changes—that is, they will not significantly affect their behavior—then purchasers will tend to bear most of the burden of an excise tax increase. The degree of responsiveness of purchasers to changes in price, of course, depends largely on the availability of substitute goods. On the other hand, if sellers of the goods are relatively unresponsive to changes in prices—that is, they will not significantly reduce their supply of the goods—then the land, labor, and capital used in the business of providing the good will tend to bear more of the burden of the tax. The degree of responsiveness of sellers to changes in price depends largely upon the availability of alternative uses for the land, labor, and capital used in producing the goods.

But it should be noted that even if the full tax burden of the proposal is shifted to purchasers, the relative change in the price of the affected goods would be quite small in relation to the effect of increase in excise taxes or tariffs. The table in my testimony illustrates that point. In the case of a pack of cigarettes, even if you assume 100 percent passthrough—and that is by no means the necessary assumption, but if you assume that—the increase in price would only be 8 percent, or 9 cents a pack. If you assume full passthrough in the case of a six-pack of beer, the increase is 3 percent, or 9 cents per six pack. For a gallon of gasoline the increase, again assuming 100 percent passthrough, is only 5 percent, or 5 cents per gallon.

The CHAIRMAN. Give me that on cigarettes again.

Mr. MENTZ. On cigarettes the increase would be 8 percent per pack, or 9 cents, assuming current price levels.

The CHAIRMAN. The reason I ask it is that this committee came to within just a vote or two of going to 32 cents a pack on cigarettes. I think it was last January or February when we were considering reconciliation.

Mr. MENTZ. I believe that is right, and that reinforces the point that, relative to the price of the goods, you are talking about really very modest amounts.

Let me get to the tax policy considerations, because I think that is probably the most important part of this testimony.

As I have already stated, the Treasury believes that the proposal to deny a deduction for the payments of Federal excise taxes is properly analyzed as similar in effect to a direct increase in excise taxes. In evaluating the proposal, it is thus necessary to consider the circumstances in which the imposition of an excise tax or an increase in the existing rates may be justified. And there are several such instances.

The first is external social costs. One traditional justification for imposing an excise tax is to ensure that the market price of a good reflects any external social costs associated with its production or consumption. The free market will efficiently allocate economic resources, to the extent that at the margin all of the economic costs to society of the goods are reflected in the price charged by the producer, and all of the economic benefits to society of the good are reflected in the price paid by the consumer. In most cases, essentially all of the costs to society of the good are borne by the producer, and hence will be reflected in the price charged by the producer. Similarly, all of the benefits to society are received by the consumer and hence will be reflected in the price that he pays.

In some cases, however, the social costs of producing or consuming a particular good exceed the costs to the producer or consumer. These external uncompensated costs are borne by other members of society who do not directly benefit from the production or consumption of the good. When these external costs are present, the imposition of an excise tax can make the allocation of economic resources more efficient by raising the price of the damaging activity and thereby internalizing the external costs.

Alcohol abuse is an example. The external costs attributable to alcohol abuse include such direct costs as property damage and personal injuries incurred by innocent victims of alcohol-related automobile accidents, as well as indirect costs, as the burden of extra health care costs shifted from an alcoholic to society at large by insurance or public health care programs.

Although excise taxes are currently imposed on alcohol and tobacco products—and, of course, with tobacco you have a similar external cost situation—many believe that current tax levels do not adequately reflect the external costs of these products. Some evidence of this widely held view is the fact that current law also restricts the advertisement of these products. And it is notable that a group of prominent economists recently has called for substantial increases in the Federal excise taxes on alcohol.

It may also be true that the market prices of gasoline and other petroleum products, particularly at current depressed levels, do not fully reflect the social costs of producing or consuming these products. For example, among the external social costs associated with gasoline consumption are air pollution and the prospect that future economic growth may be endangered by reliance on uncertain foreign supplies of oil. In addition, increased excise taxes on petroleum products may be appropriate to encourage energy conservation, and thus reflect the value of nonrenewable resources to future generations.

A second rationale is surrogate user fees. The imposition of an excise tax may be justified as a surrogate user fee, where the Federal Government provides services that directly benefit users of certain services. Examples of such surrogate user fees are the Federal excise taxes on gasoline and diesel fuels, most of the revenues from which are used for Federal-aid highway programs. Excise taxation of certain goods such as motor fuels may be justified both as a surrogate user fee and as a way to internalize external costs.

A third rationale is the situation where demand is unresponsive to price changes. Excise taxes, in certain circumstances, raise revenue with minimal distortion of consumer choices. If demand by consumers for a particular good is quite unresponsive to price changes, an excise tax on that good would cause very little change in the amount of the good consumers would purchase; that is, it would minimize distortion of the allocation of economic resources. Since a basic goal of tax policy is to raise revenue without distorting economic behavior, an excise tax in such circumstances may be a legitimate alternative to a more broadly based tax measure that does create economic distortion.

I am going to skip over use of revenues and move to distributional impact.

One of the President's principal tax reform objectives is that families below the poverty line not be required to pay Federal income taxes. The President's tax reform proposal sought, as well, to reduce the tax burden on middle income working Americans. These objectives relate to the basic fairness of the tax system and require that we carefully evaluate the distributional impact of the proposals to deny a deduction for Federal excise taxes and tariffs.

In general, the distributional effect of the proposal will depend on the extent to which the incidence of the excise taxes are passed on in price increases, as well as the consumption by different income classes of the goods and services subject to the levies. Conventional analysis of the distributional effect of excise taxes is based on the assumption that these levies are fully passed on, and on calculations using annual income and consumption data. These data typically show consumption to represent a higher percentage of income for lower income families than for higher income families, and, accordingly, the conventional analysis is that the distributional effect is regressive.

For several reasons, however, income and consumption are more closely related overtime than they are in any given year. For example, young families tend to spend a higher proportion of their incomes than middle-aged families, who tend to have higher incomes, while, at retirement, income normally falls by a greater amount than consumption. Further, in any given year, some families will maintain their normal spending levels in spite of low income, due to illness, unemployment, or windfall losses; whereas, other families will maintain normal spending patterns in spite of windfall gains. Thus, a snapshot approach, taking an annual look at whether the effect is regressive or not, is probably not the correct way of looking at the distribution.

In addition, the nature of some excise taxes suggests that their distributional consequences might properly be judged from a different perspective. As I discussed earlier, some excise taxes are justified because market prices are too low, either because they do not reflect external costs associated with the production or consumption of the particular good, or because they do not reflect government benefits provided to users of the goods. The burden of these taxes is therefore comparable to the prices paid for privately consumed goods and services. Individuals who do not consume the taxed good and therefore do not impose external costs on others or receive user benefits, do not have a tax burden. In contrast, the burden of the income tax is not directly related to any external cost or specific Government expenditure benefit. In other words, the distributional pattern is going to be different depending upon whether you are looking at smokers or nonsmokers, users of alcohol or nonusers. And for that reason, it is not the same type of analysis as in the case of the income tax, which applies to everyone.

Finally, as a matter of tax policy, you have to look at the whole distributional analysis of a tax reform proposal, not just any one particular provision. We would suggest that the appropriate way to look at the distribution, even if it is desired to factor in the effects of excise taxes, would be to complete the tax reform markup and see where we are, and then, if the conclusion is that it is too tough on the lower income families, there are a number of remedies, targeted remedies, that may be devised to alleviate the distributional hardship—that is, if the committee concludes that there is such a hardship, and I am suggesting that indeed you may not come to that conclusion.

I am going to omit going through the tax treaty, GATT, and related issues. I would be happy to take questions on them.

I think the basic point on the proposal to increase the excise tax rate on wine is that—with some statistics, perhaps, better than anything else and I think these are rather dramatic statistics—the same amount of alcohol is contained in 1 gallon of distilled spirits containing 50 percent alcohol, in other words 100 proof, 12.5 gallons of beer containing 4 percent alcohol, 2.5 gallons of still wine containing 20 percent alcohol, and 4 gallons of still wine containing 12.5 percent alcohol. And the respective excise taxes on these beverages are $12.50 on the distilled spirits, $3.63 on the beer, $1.68 on the still wine containing 20 percent alcohol, and $0.68 on the still wine containing 12.5 percent alcohol.

The chairman's proposal would bring those more into equilibrium—not completely into equilibrium, but more into equilibrium—and it seems to me those statistics speak for themselves.

Another of the chairman's proposals which the administration supports would adjust Federal excise tax rates to reflect price changes. Again, I think the most eloquent way of making this point is by the statistics.

As inflation has occurred and the prices of taxed goods have tended to rise, the amount of unit-based excise taxes has fallen, both in constant-dollar terms and as a percentage of the price of the goods. The decline in the rate of Federal excise taxes in constant dollar terms has been particularly pronounced in the case of excise taxes on alcoholic beverages. Although the Federal excise tax on distilled spirits was increased in 1985 from $10.50 per proof gallon to $12.50 per proof gallon, the rate had not previously been increased since 1951. Similarly, the Federal excise taxes on beer and wines have not been increased since 1951. If the excise taxes on these products had increased by the same percentage as consumer prices, the excise taxes on distilled spirits, beer, and wine would have risen between 1951 and 1985 from $10.50 to $43.48 per proof gallon in the case of distilled spirits, from $0.29 to $1.20 per gallon in the case of beer, and from $0.17 to $0.70 per gallon in the case of wine.

I think when you hear the testimony of subsequent witnesses who will explain how impossible it will be for the producers of these products if the excise tax were increased and how they would go out of business, I wonder why they were able to stay in business in 1951. It seems to me that is a legitimate question.

Let me just conclude, Mr. Chairman, by saying that if sufficient base-broadening measures are not adopted by the committee, and if the President's tax reform objectives are otherwise met, the administration could support excise and related tax proposals as part of a revenue-neutral tax reform bill, provided that a justification exists for increasing the level of a particular tax. As I have indicated in my testimony, the factors that may justify an increase in particular excise taxes are the existence of external costs associated with the production or consumption of the taxed good or service, the function of the tax as a surrogate user fee for goods or services supplied by the Federal Government, and the fact that a particular excise tax may cause minimal distortion of economic behavior, where demand for the taxed good is relatively unresponsive to changes in price.

Mr. Chairman, I would be glad to entertain any questions you or other members of the committee may have.

The CHAIRMAN. Mr. Secretary, I am just going to summarize as follows: If necessary, in order to meet the President's request we can't do it with enough base-broadeners, the administration would support excises?

Mr. MENTZ. That is right, Mr. Chairman. And as I have indicated, I think you have to look at each excise tax separately.

The CHAIRMAN. I agree.

Mr. MENTZ. But there is no question that when we are looking for revenue, excise taxes should be looked at and looked at very hard.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Secretary, I have never heard in any proposal by the administration or any other source, as a matter of fact, the deductibility of excise taxes referred to as "a preference," or "as an incentive" or as a "loophole." Is that correct? Can you ever recall those terms being used in connection with the deductibility of excise taxes?

Mr. MENTZ. The deductibility? No, I have not, Senator.

Senator CHAFEE. The administration's proposal had nothing like this, neither Treasury I or II suggested this approach. Even Treasury I, which was the most pure of the tax reform proposals in eliminating all preferences and loopholes, did not eliminate the deductibility of excise taxes, is that correct?

Mr. MENTZ. That is correct. And indeed, in my testimony I do not analyze the proposal as an income tax item, but rather as an increase in excise tax. I think I get to that analysis, Senator Chafee, because of the so-called antiavoidance rule which in effect requires that the nondeductibility result in a tax of 35 percent of the amount of the excise tax. I think that mechanism pulls it out of the income tax and makes it basically an increase in excise tax.

Senator CHAFEE. In other words, what is being proposed here is an increase in tax.

Mr. MENTZ. We are grateful for your support, Senator.

Senator CHAFEE. It is an increase in taxes, isn't that correct?

Mr. MENTZ. It is an increase in excise taxes across the board; that is correct.

Senator CHAFEE. Right.

Now, Mr. Secretary, when originally the whole idea of tax reform came forward, it was supposed to be revenue neutral and indeed what we have been trying to adhere to around here.

Mr. MENTZ. Correct.

Senator CHAFEE. In other words, the way you pay for the reduction in the rates for individuals and corporations is by eliminating preferences and loopholes. Isn't that correct?

Mr. MENTZ. That certainly is the preferred way.

Senator CHAFEE. What sense does it make, Mr. Secretary, to have a reduction in income taxes by having an increase in taxes somewhere else; that is, in excise taxes? That was the rationale which I and many others in this committee rejected when we rejected the increase in the gasoline tax or the import fee on oil. We did not want a tax increase to pay for a tax decrease.

Mr. MENTZ. Senator, the administration regards any increase in selective excise taxes as part of a revenue-neutral tax reform bill—that is, in total revenue neutral—as not a tax increase.

Senator CHAFEE. Wait a minute; I missed you on that one.

Mr. MENTZ. Well, look. Any time you make changes in the tax law, for example if you repeal general utilities and that results in taxes on corporations when they sell assets, looked at in isolation one might say that that is a tax increase. But it is not a tax increase if you look at it in total as part of a revenue-neutral tax bill.

Senator CHAFEE. But in that case, those fall under what we might call preferences—they are loopholes. Clifford trusts, for example, we consider an abuse.

Mr. MENTZ. Well, one man's preference is another man's basic tax provision. For example, the 3-year-basis rule for retirees, allowing them to recover their basis over 3 years before they are taxed, might well be considered to be a tax preference. And yet, the committee voted in favor of retaining that. If we continue to have those kinds of votes, we have to find our revenue somewhere else.

Senator CHAFEE. Oh, there is no question that when we finish this we have to find our revenue. But the point that we have been trying to adhere to—at least I have, and I think many others on this committee have attempted to adhere to it—is, don't go out and pay for this reduction in rates for individuals and corporations by having a tax increase someplace else. I mean, if we are going to have tax increases, I and many others on this committee feel very strongly that they should be devoted to deficit reduction. Maybe in the long run we will have to have increase in excise taxes, but it should not be used to pay for a reduction in income tax rates in the name of tax reform.

Now let me just get to a question you asked.

Mr. MENTZ. Let me respond to that. I would be glad to take your question, but the process of tax reform involves making choices that in some cases raise revenue and then it is passed through in the form of lower rates and other provisions that the committee generally will use to provide a more neutral, fairer, and a better tax system. So I don't think there is any distinction between raising an excise tax that, on the basis of good, solid tax policy ought to be raised—I don't think there is any difference between raising that and raising a tax or changing the rule on the 3-year-basis recovery for retirees. I see no distinction.

Senator CHAFEE. Well, let me just say this. My time is up, but——

Mr. MENTZ. But I took some of your time, so with the chairman's permission——

Senator CHAFEE. But I don't think you are in charge of the lottery. [Laughter.]

I will get back to this, Mr. Chairman, on the second round.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Thank you, Mr. Chairman.

Mr. Secretary, you spent a great deal of time in your testimony——

Mr. MENTZ. Probably too much.

Senator PRYOR. Mr. Mentz, I don't see any statement in your testimony relative to food prices. According to the U.S.D.A, 8 percent of food prices today relate to the cost of transportation.

Now, if we take away the deduction for excise taxes, how much do you think your proposal is going to increase the cost of food?

Mr. MENTZ. Well, Senator, first of all it is not my proposal.

Senator PRYOR. Well, I think that you just adopted it. [Laughter.]

Mr. MENTZ. Let me make it clear, in case I have confused the committee, which I frequently do, the administration will entertain the possibility of selective increases in excise taxes in order to create a revenue-neutral tax reform package.

I don't think I have adopted the across-the-board increase, the 54-percent increase, in all excise taxes; nor have I specifically adopted the method of nondeductibility as the route to getting to the result. In other words, I think another way to go—and I think the chairman alluded to this in his questioning earlier on—you could simply selectively raise certain excise taxes. And indeed, you may selectively raise them more than 54 percent if you so choose.

Senator PRYOR. Would you recommend to the President that he sign this bill if the excise tax provision, as we are now considering, is included?

Mr. MENTZ. I have gone through the tax policy reasons for making a case for increasing excise taxes. I think some of the excise taxes that are on the books today fall within that category, Senator. I think the leading ones, certainly as you have identified, are tobacco, alcohol, and motor fuels. I think some clearly do not.

Let me say that the one that most clearly does not, if we are talking about a case that really doesn't merit nondeductibility, would be the windfall profit tax, because the windfall profit tax cannot be passed on. There is no way that a producer of petroleum can pass on the windfall profit tax, because the price isn't at all flexible, it is determined by oil that is imported.

So, with that specific provision in there, I think that would be a problem for the administration.

But I think where we are, Senator Pryor, is we are exploring this area. I think the chairman has very creatively come up with an idea and an area that hasn't been looked at before. We didn't look at it, and the Ways and Means Committee didn't look at it, and he is suggesting we look at it. All I am suggesting is a perspective from which to view it.

Senator PRYOR. Well, Mr. Secretary, with all due respect, I have asked two questions. One question is, What will this excise tax proposal do to food prices? Could you answer this?

Mr. MENTZ. I do not know, but let me answer your second question more specifically: We would have a problem supporting an across-the-board 54-percent increase in all excise taxes, which I take it would affect the price of food. You are talking about trucks and tires, and so forth. So, where does that leave you?

Senator PRYOR. Yesterday I watched Donald Regan on one of the talk shows. He stated that the House-passed tax reform bill was horrible, or something like that. And, today you come before the committee expressing some reservations that I did not know about. Maybe the other committee members did, but I did not know of your reservations.

Mr. MENTZ. Reservations about what?

Senator PRYOR. Well, about whether or not you support this excise tax proposal that is before the committee at this time.

Mr. MENTZ. I am suggesting that the committee can take this excise tax proposal and modify it, and improve it, and maybe even raise more revenue from it, and make it a very constructive part of fundamental tax reform.

Senator PRYOR. Does this not become a consumption tax, ultimately, that we are talking about?

Mr. MENTZ. No; I don't think so, because it is selective; it is selective certainly on tobacco and alcohol. If you are not a consumer of tobacco or alcohol, it is not a consumption tax at all. And even gasoline and motor fuels—no, it is not as broad as a consumption tax.

Senator PRYOR. My time is up. I would just like to make a statement that I think your position is very tortured. Maybe as the day goes on we can unravel some of this.

Mr. MENTZ. It is probably just the way I have described it, Senator.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman; I apologize for being late. I have a lengthy statement, Mr. Chairman, that I would like to ask be placed in the record at the appropriate point.

The CHAIRMAN. Happily.

Senator MITCHELL. But I would like to make a few points, if I put in the time then allotted to me.

The CHAIRMAN. Go right ahead.

Senator MITCHELL. I thank you, Mr. Chairman, for the hearing. It demonstrates the fairness with which you have conducted this entire process.

Although there may be some question as to how the excise tax proposal will affect various industries and consumers, there can be no doubt that the overall result will be the same as a direct increase in excise taxes that will regressively fall hardest on those least able to pay. For that reason, I oppose the excise tax provisions now before this committee.

We started this process, and it has moved forward, as a needed change in our income tax laws, to restore fairness to the system. And the most important way to do that is to relate tax burdens more closely to ability to pay. This proposal would have the opposite effect: it would increase excise taxes that are not based on ability to pay, in order to reduce income taxes which are based on ability to pay.

This committee reported out legislation 21 years ago to make our tax system fairer by relying less on Federal excise taxes. The Excise Tax Reduction Act of 1965 reduced and repealed a number of excise taxes, with the stated objective of improving the fairness of the tax system.

This committee then found excise taxes, and I quote this committee, "objectionable in that they are regressive in their impact, absorbing a larger share of the income of low-income persons than of those with higher incomes. This stems from the fact that low-income families find it necessary to spend a higher proportion of their incomes for consumption than those with larger incomes."

Mr. Chairman, tax policy principles have not changed over the last 20 years. What this committee found then is equally true today. Yet the fiscal pressures of the last few years have forced the administration and this committee to increase a number of excise and use taxes.

Mr. Mentz, I want to say I am very disappointed but not surprised at your statement on behalf of the administration, that it could support raising excise taxes as part of this tax reform legislation. Unfortunately, under this administration the Federal Government has consistently increased reliance on these kinds of taxes.

One of the greatest misconceptions in this country today is that this administration is opposed to tax increases on the American people. That is not true. A more accurate description is that the administration is opposed to income tax increases.

In almost every year between 1981 and 1986, the administration has requested and Congress has approved payroll, excise, or user-tax fee increases. And this policy continues.

In its 1987 budget request, the administration requested 10 different payroll, excise, and user fee tax increases, totaling $19 billion over the next 3 years.

At the same time, the President says that the one thing he wants most in this tax bill, the one place where he has drawn the line in the sand, as it has been colorfully described to us, is to reduce the maximum individual income tax rate from 50 to 35 percent. That will, of course, benefit a small minority of Americans, those at the very top of the income scale, and it would be done in part by increasing excise taxes that bear disproportionately on those at the bottom and middle of the income scales.

Mr. Mentz, I think it is unconscionable for you to even say that you would support this to help reduce--you are part of the administration which says the one thing you have to have is reducing that maximum rate from 50 to 35 percent. And to propose tax increases that bear disproportionately on those at the bottom and middle to pay for tax relief for those at the very highest end of the income scale, I don't believe is a proper thing that this committee should do, and I hope we won't do it.

Mr. Chairman, do I have time left for a question?

Mr. MENTZ. May I respond?

Senator MITCHELL. Well, I haven't asked the question yet, Roger. [Laughter.]

Mr. MENTZ. I will respond after you do.

The CHAIRMAN. Go right ahead.

Senator MITCHELL. Now, you have described this proposal as, in effect, an increase in excise taxes. If that is true, is the administration prepared to propose and support direct increases in excise taxes instead of this roundabout method of accomplishing that by denying deductibility?

Mr. MENTZ. Selectively, Senator, yes. But if there is a particular excise tax where there is tax policy merit for its increase, yes, absolutely, in the context of tax reform—revenue-neutral tax reform.

Senator MITCHELL. Would you tell us, then, what selectively? Which excise tax increases does the administration now support increasing directly?

Mr. MENTZ. Well, I went through in my testimony three basic reasons why excise taxes ought to either be imposed or in some cases increased. One reason is external social costs, another one is surrogate user fees, and a third is where the demand for the product is somewhat inflexible so that revenue can be raised without significant economic distortion.

Now, let me say that some excise taxes, particularly the alcohol excise taxes, have not been raised since 1951, and a group of 67 noted economists have recommended increases in the alcohol excise taxes. I don't see that as administration support for that. I just don't see it in the same terms as you do.

You expressed your position in your usual eloquence, but somehow I just don't feel that I am all that bad a person that you are making me out to be.

Senator MITCHELL. Oh now, Mr. Mentz, you know I never suggested any such thing; I think you are terrific, myself. [Laughter.]

It is just the positions you are forced to defend. And as a lawyer who many times argued cases which were lacking in merit, I sympathize with your position. [Laughter.]

The CHAIRMAN. Senator Danforth.

Mr. MENTZ. I don't lose many of those cases, Senator.

Senator DANFORTH. No questions, Mr. Chairman.

The CHAIRMAN. Senator Long.

Senator LONG. Let me just get this straight and see just how much tax we are talking about now.

You are talking about taxes, as I understand it, on whiskey, cigarettes, wine.

Mr. MENTZ. And gas.

Senator LONG. It is up to the committee to decide which ones we want to tax, if at all.

Mr. MENTZ. That is right.

Senator LONG. Now would you get me through this? About how much, assuming the whole thing is passed through, assuming we just pass it on through in the cost of the products, how much a pack would that be as an increase on cigarettes. I see your chart on page 12 here.

Mr. MENTZ. On cigarettes I think I said it is 9 cents a pack, assuming it is fully passed through, Senator Long.

Senator LONG. Let's see. I stopped smoking those things, thank God, but what are they selling for now, do you know?

Mr. MENTZ. Yes. It is about $1.05 a pack.

Senator LONG. Well, of course, anybody who is smoking at that price, the best thing he can do is to quit smoking. I say that as a former smoker myself. But assuming that he intends on putting himself into an early grave, this would charge him an extra 9 cents for that foolishness, I take it.

Mr. MENTZ. That is right.

Senator LONG. As far as beer is concerned, how much would that be?

Mr. MENTZ. It would be about 9 cents for a six-pack, assuming, again, full passthrough.

Senator LONG. Well, let us see. That is six bottles. That works out to about 6.7 cents for—no, it is not that much.

Mr. MENTZ. No; it is a little over a penny, about 1.5 cents.

Senator LONG. About 1.46 or 1.5 cents to a bottle of beer?

Mr. MENTZ. Right.

Senator LONG. And how about whiskey? How much is that now, if you pass it through?

Mr. MENTZ. I don't have it for whiskey, Senator. I can certainly get it for you.

[The information follows:]

The proposed disallowance of a deduction for alcohol excise taxes would increase the price of a 750 milliliter bottle of whiskey by approximately $1.07, assuming the full amount of excise tax increase is passed on to consumers.

Senator LONG. Well, let us see. Somewhere here you had that on whiskey, I think.

Well, I would like to get that, then, just get it down to see how much it costs for a fifth, for example; that is the way most people buy whiskey off the shelf, a fifth or a quart.

Now, for a gallon of gas it is 5 percent; so, you are talking about roughly 5 cents on a gallon of gas, or is it 4 cents? What is it?

Mr. MENTZ. Yes; 5 cents on a gallon of gasoline.

Senator LONG. Now, none of this is any backbreaking additional charge, not any one that I can see. Of course, I take it that the gas thing would be probably a far bigger money raiser than the other two, because people use more gasoline. Is that right, or not?

Mr. MENTZ. I don't think so.

[Pause.]

Senator LONG. I would think you would raise about $4 billion a year with that gasoline item. That 4 cents a gallon I think works out to about $4 billion.

Mr. MENTZ. Yes; that is right. For all motor fuels, including diesel, it is $20.5 billion; whereas, it is $9 billion from alcohol and $7.5 billion from tobacco.

Senator LONG. That is $9 billion, but is that over a 5-year period?

Mr. MENTZ. That is all over a 5-year period, Senator Long.

Senator LONG. And including the one on cigarettes, that is over a 5-year period?

Mr. MENTZ. That is right.

Senator LONG. And how much do you expect you would get over a 5-year period on cigarettes?

Mr. MENTZ. $7.5 billion.

Senator LONG. I see. So, you would be getting about $1½ billion a year, then?

Mr. MENTZ. Yes; that is on the assumption that that is under the chairman's exact proposal. I am suggesting that the committee could decide to modify that proposal.

Senator LONG. I see.

Now, with the exception of the gasoline, most of these big revenue raisers that we would be talking about really are products that, so far as I can see, you would be better off without. I am not here to say that it doesn't make you feel better temporarily to drink some of that alcoholic product, but basically you are talking about something that the public doesn't have to buy, unless they are addicted to it.

Mr. MENTZ. That is right, and indeed there are external social costs associated with tobacco and alcohol on the nonsmoking, nondrinking public, and that provides a rationale for those excise taxes. And, especially for the ones that haven't been increased since 1951, it seems to me there is a pretty good case for increasing them.

Senator LONG. Well, I don't know how I am going to vote for it as part of the tax thing, but if I could be assured that you were going to use that money to fight drugs, I would sure vote for it. I read the article in the morning newspaper about that matter, and we really need to be doing something about that in the worst kind of way.

Thank you very much.

The Chairman. Senator Chafee.

Senator Chafee. Thank you, Mr. Chairman.

You know, it is rather curious that you are here on this, Mr. Secretary because, as I recall, the administration was very much opposed to keeping the cigarette tax at 16 cents when it was going to drop to 8. You were here resisting keeping the tax at that amount. Indeed, I had a proposal to increase the tax to 32 cents, and the administration went all out to fight that. Do you remember that?

Mr. Mentz. I remember it very well, and I remember it not only here but in the Ways and Means Committee. I was asked the question—I don't think I got the question here, but I got the question in Ways and Means. I think Congressman Matsui asked me what my position would be if the increase in excise tax on cigarettes were part of a revenue-neutral tax reform proposal. I said that that was a very different situation, and that the administration was not taking a position in that context.

So, if you want to make a proposal to increase the cigarette tax to 32 cents in the context of a revenue-neutral tax reform, I think it is something that the committee ought to look at, and the administration would not be flat opposed to it.

Senator Chafee. Let me say right there that I wouldn't make that proposal in connection with any so-called revenue-neutral measure, because it wouldn't be revenue neutral then. It would be as a result of increasing the taxes. In connection with reducing the deficit, sure, I would be glad to.

Now, let us get back to these tax increases. Somehow the suggestion is that if you increase these taxes, the amount goes right through to the consumer. For example, the material you gave us shows that there is a tax of 67 cents a gallon on wine of between 14 and 21 percent alcohol content. Now, if that is nondeductible, the feeling is that the increase in tax just goes straight through to the consumer. But I find that very, very hard to believe. I can't believe that there isn't a markup by the wholesaler of—what?—30 percent, or something like that, which then takes that upward. Then you go to the retailer. Let us say the wholesaler is at 30 percent and the retailer is at 40 percent. You would compound that increase, so it isn't just 67 cents that is going along to the consumer, it obviously must be double that. To suggest otherwise, I just don't think is quite presenting the picture in total clarity.

Mr. Mentz. Well, I think the way it would work, Senator, at least the way we think it would work, would be if you have $1 of excise tax, and it is made nondeductible and subject to this specific provision, that means that there is another 35 cents that the person who pays the excise tax, whether it is the producer or whomever, the importer, has to pay over to the Government. And that 35 cents, in order to put himself in the same position, he has to recoup not just the 35 cents but an amount equal to the income tax on the added amount that he increases his prices.

So, it seems to me that the maximum necessary to provide the importer or producer in the same position would be 54 cents; in other words, a 54-percent increase. It may be less if that importer or producer is at a tax rate that is somewhat below 35 percent.

The suggestion that the increase would be more suggests that the market will be able to withstand a greater increase in price. I don't think that is right, because if the market would withstand a greater increase in price, it would already be there. The producer or wholesaler or somebody would have already gotten to that increase.

So, I think, analytically, the increase is 54 percent, maximum.

Senator **Chafee**. Mr. Secretary, let me just say this, that what is happening with these excise taxes is that once upon a time we levied them because this was the most convenient point of collection. Since they were deductible there wasn't much of a policy issue.

If we now turn around and say they are not deductible, we are raising the taxes on those who previously just happened to be the collection point, and the situation has changed.

Let me further say that to suggest that the revenue will increase despite the amount of tax increase, I think, is ignoring some facts of life. I mean clearly—and you are familiar with these as much as I am—the yield on distilled spirits, since we increased the tax has gone down, and in Canada they have had an experience where they put the tax up and suddenly got less revenue than before because they had priced themselves out of the market.

Mr. **Mentz**. Let me just say that we have looked at all of that data. That has been factored into the revenue estimates not only by the Treasury but also by the Joint Committee staff, and I think we stand by those estimates. We believe they are based on data that support them.

The **Chairman**. Senator Pryor.

Mr. **Mentz**. Incidentally, Senator Pryor, the specific answer to the question you asked me about the cost of food: if the chairman's proposal were enacted in total, there would be an increase in price of somewhat less than one-half of 1 percent of the price of food.

Senator **Pryor**. Later on I may ask you—well, if you would, submit in writing for the record how you came to that figure.

Mr. **Mentz**. Sure.

[The information follows:]

The proposed disallowance of deductions for Federal excise taxes may affect food prices by increasing transportation costs, attributable to the excise taxes on motor fuels, trucks, and tires.

Under present law, Federal excise taxes are imposed on motor fuels, heavy trucks, truck use, and tires, as follows:

1. MOTOR FUELS

The Federal excise tax on gasoline is imposed on the producer or importer of gasoline at the rate of $.09 per gallon. The Federal excise tax on diesel fuel generally is imposed on the seller at the rate of $.15 per gallon.

2. HEAVY TRUCKS

The Federal excise tax on heavy trucks and trailers generally is imposed on the retail sale at the rate of 12 percent of the sales price. Exclusions are provided for certain trucks with a gross vehicle weight of 33,000 pounds or less.

3. TRUCK USE

The Federal excise tax is imposed annually on the user of any truck that has a taxable gross weight of at least 55,000 pounds. The rate of tax ranges from $100 for trucks with a taxable gross weight of 55,000 pounds, to $550 for trucks with a taxable gross weight of 75,000 pounds or more.

4. TIRES

A Federal excise tax is imposed on the sale of tires by a manufacturer, producer, or importer. Tires that weigh 40 pounds or less are exempt from tax. The rate of tax on other tires depends on the tire's weight. For example, the tax rate is $4.50 for a tire weighing 70 pounds and $10.50 for a tire weighing 90 pounds.

Excise taxes on motor fuels, heavy trucks, truck use, and tires are deductible, i.e., they reduce taxable income as a cost of goods sold.

Under the Chairman's plan the deduction or other reduction of income for Federal income tax purposes for the payment of Federal excise taxes, including those on motor fuels, heavy trucks, truck use, and tires, would be disallowed. This disallowance is similar in effect to a direct increase in those excise taxes. For sellers in the proposed 35 percent income tax bracket, the disallowance of the deduction for excise taxes means that a price increase equal to 54 percent of the excise tax would be required to maintain the taxpayer's prior level of after-tax profits.

For example, the retail prices of gasoline and diesel fuel would increase by approximately $.049 per gallon of gasoline and $.081 per gallon of diesel fuel, assuming that sellers are able to increase prices by the full 54 percent. These excise tax increases would raise the retail price of gasoline and diesel fuel by approximately 5 percent and 10 percent, respectively. Although excise taxes would account for a larger share of the retail price of motor fuels, that share would continue to be small relative to that in other countries. For example, for 1984 all excise taxes on gasoline averaged 17 percent of the retail price of gasoline in the United States, compared with 57 percent in France, 49 percent in Germany, 34 percent in Japan, and 25 percent in Canada.

Although the proposed increase in the excise tax on motor fuels, trucks, and tires would increase transportation costs, the percentage increase in the retail price of food would be relatively small, because transportation costs account for a small fraction of the cost of food production. According to the Department of Agriculture, only approximately 6 cents of each dollar spent for food consumed at home is attributable to transportation costs (USDA, Food Cost Review, 1984). Based on data from the Departments of Agriculture, Commerce, and Transportation, we estimate that the proposed increase in excise taxes on motor fuels, trucks, and tires would raise retail prices for food by approximately 0.3 percent, if food producers pass on the full amount of the increase in the excise taxes to consumers in higher prices.

Although the relative price of taxed goods and services would increase in response to the proposed increase in excise taxes, the general level of prices would not necessarily increase. A general increase in the price level can occur if the appropriate accommodative adjustments occur in the total supply of money (or its velocity). With an unchanged nominal value of gross national product, the general price level cannot rise in response to the tax increase, and the level of factor incomes would fall.

Senator PRYOR. Mr. Chairman, I just have two quick questions. One, I would like to know very specifically, Mr. Secretary, what changes would be necessary—in Senator Packwood's proposal on excise taxes—what changes would be necessary for you to adopt the proposal; and, two, to recommend to the President that if it came to his desk, that he would sign it.

I know you mentioned a change in windfall profits. What other changes?

Mr. MENTZ. Well, I think the way to go about it.

Senator PRYOR. I am not asking about how I go about it; I want to know how you go about it.

Mr. MENTZ. I know, and that is what I am talking about. The way I would look at it, and the way I think you have to look at it, because you ultimately have to make the decision, but I think the way to go about it is to look at each tax, each excise tax, and they are listed in appendix A, you have to decide which of those are candidates for increase.

Now in my view, in the Treasury's view, it is probably cleaner to do it as a direct increase rather than through the nondeductibility route. So, for openers, I think that is probably the better way to go.

Assuming that you go that way, I would say on this list my leading candidates for increase would be alcohol, tobacco, and motor fuels. I think your miscellaneous excise taxes, probably not.

I have not gone through all of these and tried to figure out where they fit within the three tax policy justifications that I have. gone through, but looking at the airport and airway trust fund taxes, I don't see offhand why we would be better off raising the taxes on air transportation, for example. The same is true for black lung disability insurance; I don't think that is a particular candidate for increase.

I have not gone through every one of these, but if you want me to, I will, but I think the leading candidates and the ones where the revenue is the most important are alcohol, tobacco, and gasoline.

On gasoline, I might say if you look at what is happening to the price of gasoline, you could put an excise tax increase on gasoline and not even feel it, the way the price is going down at the pump.

Senator PRYOR. What about an import oil fee on gasoline? If you want to raise money on gasoline, would not this be a more painless way of doing it?

Mr. MENTZ. Well, an oil import fee has its problems. I testified on that before Senator Wallop's subcommittee at the end of February. Let me say that at a particular price level, there may be justification—at least, I think this is the President's position—there may be justification for an oil import fee. However, an oil import fee creates problems for the Northeast which relies on oil for heating fuel. It also would create problems with international competitiveness, because it increases the cost of goods manufactured where oil is a high component; it makes them less competitive with imports.

But as an overall statement, I did not rule out an oil import fee when I testified. I believe the President has not ruled it out at a particular price level. But recognize that there are major problems with implementing an oil import fee. It is an option that I think you would want to think about very carefully before you start down that road.

Senator PRYOR That is all I have right now, Mr. Chairman.

Thank you, Mr. Secretary.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman.

Mr. Mentz, I am disappointed that the Treasury has not produced information showing the distributional effects of this proposal. You have been able to do that with respect to previous proposals, including the oil import fee, which you just mentioned.

I have an excerpt from a study done by a private firm, De Seve Economics. It was, I believe, prepared or the firm was retained by those who are opposed to the legislation; therefore, I think it is fair to state that if that may be deemed to impair its accuracy or objectivity.

It concluded that these excise tax provisions would take back 83 percent of the income tax reductions for low income persons. My question to you is, Do you agree with that analysis, or do you dispute it, and if so on what basis and in what amount?

Mr. MENTZ. It seems to me that applying a distributional analysis to excise taxes that are targeted—tobacco, alcohol—that apply to some members of the public but not others is somewhat of a wrong approach to take.

A distributional analysis of an income tax makes sense, because everybody has to pay an income tax. But you don't have to pay an excise tax on alcohol if you don't drink alcohol. You don't have to pay it on cigarettes if you don't smoke cigarettes.

So, your distributional analysis, and that distributional analysis that De Seve made, lumps everybody in the lower income levels, smokers and nonsmokers, drinkers and nondrinkers. It seems to me that is the wrong approach. That is the reason that there is no analysis in this testimony, because it just seems to me that it doesn't provide meaningful information.

Senator MITCHELL. Well, accepting that for purposes of argument—I don't accept your analysis, but accepting it for purposes of argument—do you know of any reason to dispute the accuracy of the data contained in that report?

Mr. MENTZ. I am not familiar with that report, so I really can't comment.

Senator MITCHELL. Are you familiar with any distributional analysis of this proposal? Or have you simply concluded, for the reasons previously stated, that it is not a valid concept?

Mr. MENTZ. Yes. We concluded that it would not be appropriate or provide useful guidance to the committee to do a distributional analysis of selected excise taxes that would apply not to the general public at large. That is the reason it is not furnished for you.

Senator MITCHELL. Not to mention the fact that it probably wouldn't support your position.

Mr. MENTZ. Well, I don't know, maybe it would. I just haven't looked.

Senator MITCHELL. Thank you very much, Mr. Mentz.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. I have no questions, Mr. Chairman.

The CHAIRMAN. Senator Long?

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Chafee, any more?

Senator CHAFEE. Yes.

One point that I find confusing in your testimony, Mr. Mentz, is that you say look at each tax and ask which are the candidates for increases. Yet, in addition to all of that, you recommend indexing these taxes in accordance with the selling price. Now, it seems to me that those two statements are contradictory.

I want to just say that I personally am opposed to the indexing. I am opposed to all indexing anyway, but this business of indexing these taxes in accordance with the selling price, it seems to me, lets it get away from the periodic appraisal this committee should be making. We should look at the cigarette tax, the wine tax, beer tax, liquor tax, whatever it is, and decide whether it should be increased. Presumably we would make a judgment based on a series of factors. Obviously indexing the taxes would remove this discretion and would be inconsistent with your suggestion that we look at each tax and decide which needs increasing.

Mr. MENTZ. I think the position that you stated is certainly consistent with your position on indexing generally, and I respect it.

I will just make a technical point: the way to do this would not be to make it an ad valorem tax that would simply vary with the price, but rather to adjust it on some Consumer Price Index or something like that. That would be a technically better way of doing it.

I guess all I can say back to you is that I think the Treasury view is that the chairman has a good idea here, and it is consistent with the administration's policy on indexing the rate brackets and other forms of indexing. That is the reason we support it.

Senator CHAFEE. Let me conclude by emphasizing a point that has already been made here, today—excise taxes have no relationship to ability to pay.

Now, you are saying if you don't want to smoke, you don't have to pay the tax; if you don't want to drink, you don't have to pay the tax. That hardly applies to a gasoline tax, but let us not pursue that.

As far as any increase in the gasoline tax, I would be receptive to that, but not in connection with this so-called revenue-neutral tax reform bill, only in connection with reducing the deficit.

Thank you very much, Mr. Mentz.

Mr. MENTZ. Let me just say that if we can do sufficient base-broadening so that we can come out revenue neutral without excise taxes, God bless us all. But I just have a feeling that we are going to need them, and I think the chairman has focused on an area that needs revisiting. I don't think it has been approached for a long time, since 1951 in the case of alcohol taxes other than on distilled spirits. For that reason, I think it is very appropriate for the committee to consider them.

The CHAIRMAN. Mr. Secretary, thank you very much.

Mr. MENTZ. Thank you, Mr. Chairman.

The CHAIRMAN. Senator McConnell.

[The prepared written statement of Mr. Mentz follows:]

For Release Upon Delivery
Expected at 9:30 a.m., EST
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STATEMENT OF
J. ROGER MENTZ
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to discuss the Treasury Department's views regarding the proposals in Chairman Packwood's tax reform markup document (the "Chairman's Plan") relating to Federal excise taxes and tariffs. The proposals would make Federal excise taxes and tariffs nondeductible for Federal income tax purposes, increase the rate of Federal excise tax on certain wines to the rate currently applied to beer, and adjust the rates of Federal excise tax on alcohol and tobacco products and certain fuels to reflect future price increases.

The achievement of fundamental tax reform is a central goal of this Administration. In the President's view, the key elements of a revenue-neutral tax reform bill are a full $2,000 personal exemption for both itemizers and nonitemizers, at least for individuals in the lower- and middle-income tax brackets; a rate structure with a maximum rate no higher than 35 percent; tax brackets that reduce taxes for middle-income working Americans; basic tax incentives for American industries, including those which depend upon heavy capital investment in equipment and machinery; and a minimum tax which allows no individual or business to escape paying a fair share of the overall tax burden. The President believes that these changes will promote future economic growth, improve the fairness of the tax system, and simplify the system for millions of individual taxpayers.

As the tax reform process has moved forward, the Administration, the House Ways and Means Committee, and now the Senate Finance Committee have come to recognize the difficulty of raising enough revenue from the income tax system to accomplish fundamental changes. The Administration's tax reform proposals did not include provisions comparable to those in the Chairman's Plan relating to excise taxes and tariffs. Instead, we proposed general base broadening to maintain the revenue neutrality of our tax reform plan. We encourage renewed consideration of those tax reform proposals made by the Administration and not incorporated in the Chairman's Plan that would raise additional revenues. In addition, we support efforts by the Committee to develop alternative revenue raising proposals that are consistent with the President's tax reform goals. If, however, the base-broadening and other revenue raising proposals that are accepted by the Committee do not raise sufficient revenues, we could support raising revenue through excise tax changes in the context of revenue-neutral tax reform that meets the President's goals. It is in that spirit that we consider the excise tax and tariff proposals that are included in the Chairman's Plan.

My testimony is divided into three major sections, corresponding to the three proposals in the Chairman's Plan relating to excise taxes and tariffs: the denial of an income tax deduction for Federal excise taxes and tariffs; an increase in the excise tax rate on wine; and adjustments in certain excise tax rates to reflect price changes. The proposal to deny the deductibility of Federal excise taxes and tariffs raises the most revenue and requires more complex analysis than the other two proposals, so I will turn to it first.

Proposal to Deny Deductibility of Federal Excise Taxes and Tariffs

Background

Under current law, Federal excise taxes and tariffs are imposed on a wide range of goods, services, and activities. For fiscal year 1986, total Federal excise tax revenues are estimated to be over $34 billion. Of this amount, approximately $17 billion are general tax revenues and the remaining $17 billion are earmarked for designated spending purposes. This earmarking occurs by way of an automatic appropriation to a segregated trust fund, such as the Highway Trust Fund, of an amount equivalent to the receipts from certain excise taxes. A schedule listing the significant Federal excise taxes and the amount of projected revenues for fiscal year 1986 is attached as Appendix A. During calendar year 1985, total Federal tariff collections were approximately $11.5 billion. A schedule listing the major categories of Federal tariffs is attached as Appendix B. Although it is not possible in the time that is available to me to discuss each of the Federal excise taxes and tariffs, a brief description of several of the excise taxes and tariffs that generate very substantial revenues may be helpful.

Distilled Spirits. The Federal excise tax on distilled spirits is imposed on the producer or importer of distilled spirits at the rate of $12.50 per "proof gallon." This rate was increased in October 1985 from $10.50 per proof gallon. A proof gallon is the volume of distilled spirits containing the same amount of alcohol as one gallon of 100 proof (50 percent alcohol) distilled spirits. For example, one gallon of 80 proof distilled spirits is equal to 0.8 proof gallons, and is subject to a Federal excise tax of $10.00. In general, the excise tax on distilled spirits becomes payable when the spirits are removed from the bonded premises of the producer or importer. The excise tax typically is treated as a cost of goods sold in determining the taxable income of the taxpayer. The distilled spirits excise tax is expected to generate receipts of $4.0 billion in fiscal year 1986. Revenues from the tax are included in the general fund.

Wine. The Federal excise tax on wine is imposed on the producer or importer of the wine. The rate of tax varies depending on the alcohol content and carbonation of the wine, as follows: $0.17 per gallon (a standard measure gallon as opposed to a proof gallon) on still wines containing not more than 14 percent alcohol; $0.67 per gallon on still wines containing more than 14 percent alcohol and not more than 21 percent alcohol; $2.25 per gallon on still wines containing more than 21 percent and not more than 24 percent alcohol; $2.40 per gallon on artificially carbonated wines; and $3.40 per gallon on champagne and other sparkling wines. Wines containing more than 24 percent alcohol are taxed as distilled spirits. In general, the tax becomes payable when the wine is removed from the bonded premises of the producer or importer. The excise tax typically reduces taxable income as a cost of goods sold. Wine excise tax receipts are expected to be $276 million in fiscal year 1986. Revenues from the tax are included in the general fund.

Beer. The Federal excise tax on beer is imposed on the producer or importer of the beer. The rate of tax is $0.29 per gallon ($0.226 per gallon in the case of certain small domestic producers), and does not vary based on alcohol content. In general, the excise tax on beer becomes payable when the beer is removed from the bonded premises of the producer or importer. The excise tax typically reduces taxable income as a cost of goods sold. Beer excise tax receipts are expected to be $1.6 billion in fiscal year 1986. Revenues from the tax are included in the general fund.

Tobacco Products. The Federal excise taxes on cigarettes and certain other tobacco products are imposed on the manufacturer or importer of the products. The rate of tax on most cigarettes is $8.00 per thousand ($0.16 per pack of 20). In 1983, this rate was temporarily increased to the present level from $4.00 per thousand ($0.08 per pack of 20); the rate has been fixed at the present level by the Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272). In general, the excise taxes on tobacco products become payable when the products are removed from the bonded premises of the manufacturer or importer. The taxes typically reduce taxable income as a cost of goods sold. Excise tax receipts from tobacco products are expected to be $4.6 billion in fiscal year 1986. Revenues from the taxes are included in the general fund.

Gasoline. The Federal excise tax on the sale or use of gasoline is imposed on the producer or importer of gasoline at the rate of $0.09 per gallon. The tax becomes payable at the time of the sale or use by the producer or importer. The tax typically reduces taxable income as a cost of goods sold. After accounting for refunds and other adjustments, the gasoline tax is expected in fiscal year 1986 to yield $8.6 billion to the Highway Trust Fund and an additional $71 million to the Aquatic Resources Trust Fund. Revenues included in the Highway Trust Fund are used for Federal-aid highway and other ground transportation programs.

Diesel Fuel. The Federal excise tax on diesel fuel is imposed on the seller (or, in the absence of a sale, on the user) of diesel fuel used in a diesel-powered highway vehicle. The rate of tax is $0.15 per gallon. This rate was increased in August 1984 from $0.09 per gallon. The tax becomes payable at the time a sale is made to an owner or operator of a diesel-powered highway vehicle (or, in the absence of a sale, at the time the fuel is used in a diesel-powered highway vehicle). The tax typically reduces taxable income as a cost of goods sold. Receipts from the diesel fuel excise tax are expected to be $2.6 billion in fiscal year 1986. Revenues from the tax are included in the Highway Trust Fund.

Heavy Trucks and Trailers. The Federal excise tax on heavy trucks and trailers is imposed on the person who makes a retail sale of (or, in the absence of a retail sale, who uses) a truck or trailer chassis or body, or of a tractor of the kind chiefly used for highway transportation in combination with a trailer or semitrailer. The rate of tax is 12 percent of the sales price of the truck or trailer. Exclusions are provided for truck chassis or bodies suitable for use with a vehicle having a gross vehicle weight of 33,000 pounds or less and for trailer and semitrailer chassis and bodies suitable for use with a vehicle having a gross vehicle weight of 26,000 pounds or less. The tax typically reduces taxable income as a cost of goods sold. Receipts from the heavy truck and trailer tax are expected to be $1.2 billion in fiscal year 1986. Revenues from the tax are included in the Highway Trust Fund.

Highway Truck Use. The Federal highway truck use tax is an annual tax imposed on the user of any truck that (together with the trailers customarily used in connection with trucks of the same type) has a taxable gross weight of at least 55,000 pounds. The rate of tax ranges from $100 per year, in the case of trucks having a taxable gross weight of 55,000 pounds, to $550 per year, in the case of trucks having a taxable gross weight of over 75,000 pounds. These tax rates were reduced, and the weight threshold increased, in July 1984, in conjunction with the increase in diesel fuel tax rate described above. The highway truck use tax typically is deducted as an ordinary and necessary business expense. Receipts from the tax are expected to be $0.4 billion in fiscal year 1986. Revenues from the tax are included in the Highway Trust Fund.

Telephone Communications. The Federal telephone communications tax is imposed on any person paying for local telephone, toll telephone, or teletypewriter exchange service. The tax is collected by the service provider. The rate of tax is equal to three percent of the amount paid for such communications services. In the case of telephone services purchased by businesses, the tax typically is deducted as an ordinary and necessary business expense. In the case of telephone services purchased by nonbusiness customers, the tax typically is treated as a personal expense for which no deduction is allowed. Receipts from the telephone communications tax are expected to be $2.6 billion in fiscal year 1986. Revenues from the tax are included in the general fund.

Air Transportation. The Federal air transportation tax is imposed on any person paying for transportation by air that begins and ends in the United States or in a zone encompassing parts of Canada and Mexico that are within 225 miles of the continental United States. The tax is collected by the service provider. The rate of tax is equal to eight percent of the amount paid for such transportation. In the case of air transportation purchased by businesses, the tax typically is deducted as an ordinary and necessary business expense. In the case of air transportation purchased by nonbusiness customers, the tax typically is treated as a personal expense for which no deduction is allowed. Receipts from the air transportation tax are expected to be $2.6 billion in fiscal year 1986. Revenues from the tax are included in the Airport and Airway Trust Fund. These funds are used to cover the cost of Federal Aviation Authority operations, provide for air traffic control modernization, and provide grants for airports.

Windfall Profit Tax. The crude oil windfall profit tax is imposed on the producer of domestically-produced crude oil. Foreign-produced crude oil imported into the United States is not subject to the tax. The producer is the person holding the "economic interest" with respect to the oil. This economic interest is normally shared by various parties (including owners of royalty interests) who participate in the production of the oil. The tax applies to the "windfall profit" element in each barrel, *i.e.*, the excess (if any) of the removal price of the oil over its inflation-adjusted "base price," less an adjustment for any state severance tax. The base price of the oil and the rate of windfall profit tax vary depending on the classification ("tier") of the oil and the identity of the producer. The current average base prices of Tier 1, Tier 2, and Tier 3 oil are $18.43, $21.93, and $28.75, respectively. The rates of tax on the windfall profit element of the oil range from 70 percent on Tier 1 oil to 22.5 percent on Tier 3 oil. Independent producers are taxed at lower rates than integrated oil producers on Tier 1 and Tier 2 oil, and are not taxed at all on stripper well oil. The windfall profit tax typically is deducted by the producer as an itemized deduction under section 164(a)(5). The Administration's 1987 Budget forecast of receipts in fiscal year 1986 from the windfall profit tax was $4.2 billion. At current price levels for crude oil, however, the windfall profit tax is not expected to generate a significant amount of revenue. Revenues from the windfall profit tax are included in the general fund.

Tariffs. Federal tariffs are imposed on the importer of the product and become payable when the product enters the customs territory of the United States. Tariffs typically reduce the importer's taxable income as a cost of goods sold. Tariff revenues are included in the general fund.

During 1984, total Federal tariff collections were equal to 3.7 percent of the value of all goods imported into the United States. No tariff is imposed on certain categories of imported goods, so that the average tariff rate on imported goods actually subject to tariff was 5.5 percent of value. Tariff rates vary widely, moreover, among general product categories and among the particular products within each general product category. For example, on a trade-weighted basis, textile fibers and products (including apparel) imported into the United States are subject to an average tariff rate of 19.8 percent of the value of the product. Within this category, men's or boy's wool knit coats, suits, trousers, slacks, and shorts generally are subject to a tariff rate of 31.4 percent, while men's and boy's cotton knit shirts and sweaters generally are subject to a tariff rate of 21 percent.

Description of the Proposal

The Chairman's Plan would disallow any deduction or other reduction of income for Federal income tax purposes for the payment of any Federal excise tax or tariff. Thus, the amount of any Federal excise tax or tariff could not be deducted as an ordinary and necessary business expense or an expense incurred for the production of income, offset against income from the sale of property as a cost of goods sold, or added to the adjusted basis of depreciable property. The legal incidence of several Federal excise taxes would be clarified or changed to reduce the number of situations in which the ultimate consumer of the taxable good or service would be the person liable for the tax. For example, the legal incidence of the telephone communications and air transportation taxes would be shifted to the person providing the services. Presumably, no change would be made with respect to those excise taxes (such as the excise taxes on certain "prohibited transactions" of tax-exempt organizations and on certain "golden parachute" payments) that are nondeductible under current law.

The proposal also includes an "anti-avoidance" rule to ensure that the deduction disallowance has the effect of increasing the income tax liability of the payor of the excise tax or tariff by the amount of the tax or tariff multiplied by the maximum corporate income tax rate. For example, if the legal incidence of an excise tax falls on a corporation with net operating losses, an individual taxed at a marginal rate of less than 35 percent, or a foreign person not otherwise subject to tax in the United States, the corporation, individual, or foreign person would be treated as having a separate "basket" of income equal to the amount of the excise tax or tariff. The income in this basket could not be reduced by any deductions, and would be taxed at the maximum corporate income tax rate of 35 percent. The resulting tax could not be offset by credits.

Our preliminary estimate is that the proposal would raise $66.5 billion over fiscal years 1986-1991. The major components of this revenue increase are as follows:

	1986-1991 Amount ($ Billions)
Excise Taxes:	
Alcohol	9.0
Tobacco	7.5
Gasoline	15.5
Diesel Fuel	5.0
All Other Excises	13.6
Total Excises	50.6
Tariffs	15.9
Total	66.5

All of the additional income tax revenues would be included in general revenues.

Discussion

Although the denial of a deduction for Federal excise taxes and tariffs would, in form, affect only Federal income tax liabilities, we believe the proposal would be similar in effect to, and thus is appropriately analyzed as, a direct increase in Federal excise taxes and tariffs. As with a direct increase in these levies, the additional tax burden resulting from the proposal would vary directly with the number of units sold subject to the tax. For example, under the proposal, as under the existing cigarette excise tax, domestic sales of cigarettes by a cigarette manufacturer would generate tax liabilities proportional to the number of cigarettes sold. In contrast, liabilities under the income tax are not based on the number of units sold, but rather on the return to equity capital used in the production of the particular good.

Although we believe the proposal is similar in effect to a direct increase in excise taxes and tariffs, it should be noted that the amount of this effective increase will vary with the marginal tax rate of the person subject to the levy. As with a direct increase in excise taxes and tariffs, sellers of the taxed goods will attempt to avoid the economic burden of the proposal by passing that burden on to purchasers in the form of higher prices. The price increase required to shift the burden fully to purchasers will depend, however, on the marginal income tax rate that applies to the seller. For sellers in the 35 percent income tax bracket, a price increase equal to 54 percent of excise tax and tariff liabilities would be required to maintain the prior level of after-tax profits.*

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* If excise taxes are deductible as under current law, a 35 percent bracket taxpayer subject to a one dollar excise tax must increase his prices by one dollar in order to cover that liability and leave his income tax liability (and hence his after-tax income) unchanged. If, as under the proposal, the one dollar excise tax is no longer deductible, the taxpayer must increase prices by an additional amount to cover the income tax attributable to the lost one dollar deduction, plus the income tax attributable to the price increase. In other words, a price increase will create additional income tax liability that will, in turn, require an additional price increase. Thus, a 35 percent bracket taxpayer will not fully recover the extra income tax liabilities from the lost deduction unless his prices are increased by $.54. The $.54 is equal to the $.35 income tax on the lost deduction (35% x $1.00 = $.35), plus the $.19 income tax on the price increase (35% x $.54 = $.19). A larger price increase would be required in the case of an *ad valorem* tax, since any price increase would increase the taxpayer's excise tax liability as well as his income tax liability.

For taxpayers with less than a 35 percent marginal tax rate, the effective increase in excise tax or tariff rates will be somewhat smaller. For example, taxpayers with a zero marginal tax rate would be required to pay an income tax of 35 percent of their Federal excise and tariff payments under the proposal's "anti-avoidance" rule. Such taxpayers could maintain their after-tax income by increasing prices by 35 cents for each dollar of current excise tax or tariff liability. Thus, for these taxpayers the proposal is equivalent to only a 35 percent increase in excise taxes and tariffs.* Taxpayers subject to income tax at a rate between zero and 35 percent are in an intermediate position; to maintain after-tax income they must increase their prices by between 35 percent and 54 percent of their excise taxes and tariffs, depending on their marginal income tax rate. Also in an intermediate position are taxpayers with net operating losses. Although their current marginal tax rate is zero, net operating losses used to offset current price increases would no longer be available to offset possible taxable income in future years.

Economic Effects

The ability of sellers to shift the tax burden under the proposal to purchasers depends on the responsiveness of purchasers and sellers of the taxed good to changes in price. If purchasers are relatively unresponsive to such changes (*i.e.*, they will not significantly reduce their purchases of the good if the price increases), then purchasers will tend to bear more of the burden of an excise tax on the good than will sellers of the good. The degree of responsiveness of purchasers to changes in price depends largely on the availability of substitute goods. On the other hand, if sellers of the good are relatively unresponsive to changes in price (i.e., they will not significantly reduce their supply of the good if the price they receive for the good decreases), then land, labor, and capital used in the business of providing the good will tend to bear more of the burden of the tax. The degree of responsiveness of sellers to changes in price depends largely on the availability of alternative uses for the land, labor, and capital used in producing the good.

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* As in the preceding example, under current law, taxpayers with no marginal income tax liability need to increase prices by only one dollar in order to cover a one dollar excise tax liability and leave their after-tax income unchanged. Under the proposal, these taxpayers must increase prices by an additional $.35 to cover the $.35 "anti-avoidance" tax and thus leave their after-tax income unchanged. Because the $.35 increase in price would not create additional income tax liability, no additional price increase would be required.

In the very long run, the supply of most goods can be expected to be highly responsive to changes in price, since with sufficient time the quantity supplied of most goods can be increased (or decreased) at a relatively constant unit cost. If sellers are unable to pass on to purchasers the full amount of an of excise tax or other cost increase, the rates of return to land, labor, and capital used in the industry will fall. The reduced rates of return will cause land, labor, and capital that would otherwise have been employed in providing the good to be employed in other sectors of the economy that offer a higher rate of return. In theory, the rates of return to land, labor, and capital in different sectors of the economy would move back toward equilibrium over time, and the burden of the excise tax or other cost increase would be fully reflected in prices. Depending on the responsiveness of the purchasers to price increases, the long-run shift of the excise tax to purchasers may result in a relatively small or a relatively large reduction in the market for the good.

The magnitude of the reduction in the market for the good will largely determine how quickly the adjustment to the new equilibrium takes, how disruptive it may be, and the extent of its effect on markets for other goods. Any reduction in the market for the good as a result of an increase in excise taxes would in turn reduce the amount of land, labor, and capital required to produce the good. Over time these factors of production would find employment in other industries, but during the transition period there could be windfall losses in the form of reduced earnings, or even unemployment. At the same time, land, labor, and capital employed in producing goods not subject to excise taxes, goods which have become relatively cheaper, may receive windfall gains as purchases of those goods increase.

It should be noted that even if the full tax burden of the proposal is shifted to purchasers, the relative change in the price of the affected goods would be quite small in relation to the effective increase in excise taxes or tariffs. The table below illustrates this point.

	Approximate Percentage Increase in Retail Price Due to Nondeductibility Assuming:	
Product	50 Percent Tax Passthrough	100 Percent Tax Passthrough
Pack of 20 cigarettes a/	4.0%	8%
Six-pack of beer b/	1.5	3
Gallon of gasoline c/	2.5	5

a/ Retail price of $1.05, from industry sources, used in calculations. Current Federal excise rate is $.16.

b/ Retail price of $3.21, from industry sources, used in calculations. Current Federal excise rate is approximately $.16.

c/ Retail price of $.91 as reported in the Oil and Gas Journal for the week of April 9, used in calculations. Current Federal excise rate is $.09.

Special Circumstances

Although valid as a general model, the above analysis as to the economic effects of the proposal must be modified in certain circumstances. For some goods, long-run supply will not be highly responsive to price changes because the factors (land, labor, and capital) used to produce the good are quite specialized to its production. These factors are in limited supply and exhaustible, such as oil reserves, or have few (if any) alternative uses, and therefore cannot be shifted to the production of alternative goods. For such goods, even in the long run, the burden of an excise tax is borne at least partially by the specialized factors, rather than entirely by purchasers.

Second, the burden of an excise tax will not be passed on to purchasers where the tax does not apply to all producers of the good, and the market price is determined by reference to goods that are not subject to the tax. In particular, the windfall profit tax cannot be passed on to purchasers because the price of oil is determined in the world market, which does not reflect an excise tax imposed strictly on domestic production. All of the additional windfall profit tax burden under the proposal would therefore be borne by owners of domestic oil.

Third, although an increase in excise taxes or tariffs generally will cause temporary market dislocations, if a market is already disrupted because prices are below their long-run equilibrium level, an increase in excise taxes or tariffs may be stabilizing. This may be true currently for petroleum markets, where the recent large decline in oil prices arguably has reduced the price for oil and possibly other energy products below their long-run equilibrium level.

Finally, it is possible that sellers of a good or service subject to an excise tax or tariff will be differentially affected by the proposal. As noted above, the effect of the proposal on an individual seller will depend on the seller's marginal income tax rate. If the market price of a good is determined by sellers in the 35 percent income tax bracket, full passthrough to customers of the additional tax burden from the proposal would produce a price increase of 54 percent of excise tax or tariff liabilities. Sellers of the good with marginal income tax rates of less than 35 percent also will raise their prices by 54 percent of the excise tax or tariff, but could have recovered the excise tax or tariff with a smaller increase. Thus, in these circumstances, low-bracket taxpayers would receive a windfall (notwithstanding the anti-avoidance rule). Similar differential effects on sellers would occur in any market where at least a portion of the tax burden is passed on to purchasers, and different sellers are in different marginal income tax brackets.

Effect on International Trade

The proposal to deny an income tax deduction to the payor of an excise tax would have a mixed effect on the international trade position of the United States. Excise taxes on consumer goods such as alcohol and tobacco products are applied equally to imported as well as domestically-produced goods. Therefore, domestically-produced goods of this type would generally not be advantaged or disadvantaged by the proposal as compared to foreign-produced goods. Excise taxes that apply to goods and services purchased in significant quantities by businesses, such as trucks, fuels, and telephone services, would increase costs, and eventually prices, of a wide range of domestically-produced goods. Since comparable levies could not be imposed on imports that use such goods and services, some domestic producers would be disadvantaged by the proposal. In contrast, domestic producers that compete with imports would be advantaged by.

the effective increase in tariffs under the proposal. The effects on imports and exports would to some extent offset, and, on balance, we would expect a relatively small decline in the level of exports and imports.

Tax Policy Considerations

Justification for Selective Excise Taxes. As I have already stated, we believe that the proposal to deny a deduction for the payment of Federal excise taxes is properly analyzed as similar in effect to a direct increase in excise taxes. In evaluating the proposal, it is thus necessary to consider the circumstances in which the imposition of an excise tax or an increase in existing rates may be justified.

1. External Social Costs. One of the traditional justifications for imposing an excise tax is to ensure that the market price of a good reflects any external social costs associated with its production or consumption. The free market will efficiently allocate economic resources to the extent that, "at the margin," all of the economic costs to society of the good are reflected in the price charged by the producer and all of the economic benefits to society of the good are reflected in the price paid by the consumer. In most cases, essentially all of the costs to society of the good are borne by the producer, and hence will be reflected in the price charged by the producer. Similarly, essentially all of the benefits to society are received by the consumer, and hence will be reflected in the price paid by the consumer. In some cases, however, the social costs of producing or consuming a particular good exceed the cost to the producer or consumer. These external, uncompensated costs are borne by other members of society who do not directly benefit from the production or consumption of the good. When external costs are present, the imposition of an excise tax can make the allocation of economic resources more efficient by raising the price of the damaging activity and thereby internalizing the external cost.

For example, it is widely accepted that the public health and other social costs resulting from the consumption of alcoholic beverages and tobacco products would not be reflected in the price for these products that would be set by market factors alone. To illustrate, the external costs attributable to alcohol abuse include such direct costs as property damage and personal injuries incurred by innocent victims of alcohol-related auto accidents, as well as such indirect costs as the burden of extra health care costs shifted from an alcoholic to society at large by insurance or public health care programs. Although excise taxes are currently imposed on alcohol and tobacco products, many believe that the current tax levels do not adequately reflect the external costs of these products. Some evidence that this view is widely held is the fact that current law also places restrictions on the advertisement of these products. It is notable as well that a group of prominent economists recently has called for substantial increases in the Federal excise taxes on alcohol.*

It also may be true that the market prices of gasoline and other petroleum products, particularly at the current depressed levels, do not fully reflect the social costs of producing or consuming these products. For example, among the external social costs associated with gasoline consumption are air pollution and the prospect that future economic growth may be endangered by reliance on uncertain foreign supplies of oil. In addition, increased excise taxes on petroleum products also may be appropriate to encourage energy conservation and thus reflect the value of nonrenewable resources to future generations.

2. Surrogate User Fees. The imposition of an excise tax also may be justified as a surrogate user fee where the Federal government provides services that directly benefit users of certain goods or services. Examples of such surrogate user fees are the Federal excise taxes on gasoline and diesel fuels, most of the revenues from which are used for Federal-aid highway programs. Excise taxation of certain goods, such as motor fuels, may be justified both as a surrogate user fee and as a way to internalize external costs.

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* A group of 67 economists, including Nobel laureates Franco Modigliani, Paul Samuelson, and James Tobin, has signed a petition supporting efforts to increase Federal excise taxes on alcoholic beverages and eliminate or modify the differential tax treatment between beer, wine, and distilled spirits. See Tax Notes, March 17, 1986, p. 1178.

3. Demand Unresponsive to Price Changes. A final justification for imposing excise taxes is their ability, in certain circumstances, to raise revenue with minimal distortion of consumer choices. If demand by consumers for a particular good is quite unresponsive to price changes, an excise tax on that good would cause very little change in the amount of the good consumers would purchase. Hence, distortion of consumer choices would be minimized. Since a basic goal of tax policy is to raise revenue without distorting economic behavior, an excise tax may in some circumstances be a legitimate alternative to more broadly based tax measures.

Use of Revenues

Excise taxes serve to reflect external social costs or user benefits in two ways. First, by increasing the price of the taxed good, they reduce demand for the good and thereby the level of associated external costs, or the need to provide associated user benefits. Second, the excise taxes provide revenues to help pay for associated external costs or user benefits. These revenues may be used directly in related government programs, for example, to finance highway construction. These revenues also may be used to reduce other Federal taxes, and thus provide indirect compensation for the external costs borne by private persons. Excise taxes on goods with price-unresponsive demand also could provide revenue to replace revenues from other sources that distort economic behavior to a greater extent. Thus, under the proper circumstances, we believe it would be reasonable to use certain excise tax revenues as a means of reducing income tax burdens, as the Chairman's Plan contemplates.

Distributional Impact

One of the President's principal tax reform objectives is that families below the poverty line not be required to pay Federal income taxes. The President's tax reform proposals sought as well to reduce the tax burden on middle-income working Americans. These objectives relate to the basic fairness of the tax system, and require that we carefully evaluate the distributional impact of the proposal to deny a deduction for Federal excise taxes and tariffs.

In general, the distributional effect of the proposal will depend on the extent to which the incidence of the excise taxes and tariffs are passed on in price increases, as well as on the consumption by different income classes of the goods and services subject to the levies. Conventionally, analysis of the distributional effect of excise taxes is based on the assumption that these levies are fully passed on to customers, and on calculations using annual income and consumption data. These data show consumption to represent a higher percentage of income for lower-income than for higher-income families. Accordingly, these conventional calculations would show the distributional effect of the proposal to be regressive.

For several reasons, however, income and consumption are more closely related over time than they are in any given year. For example, young families tend to spend a higher proportion of their incomes than middle-aged families (who tend to have higher incomes), while at retirement, income normally falls by a greater amount than consumption. Further, in any given year, some families will maintain their "normal" spending levels in spite of low income due to illness, unemployment or windfall losses, while other families will maintain "normal" spending patterns in spite of windfall gains. Thus, relying on annual consumption data to distribute the excise tax burden makes these taxes appear to be more regressive than they would if lifetime consumption and income data were relied upon.*

In addition, the nature of some excise taxes suggests that their distributional consequences might be properly judged from a different perspective. As discussed earlier, some excise taxes are justified because market prices are too low, either because they do not reflect external costs associated with production or consumption of the good, or because they do not reflect government benefits provided to users of the good. The burden of these taxes is therefore comparable to the prices paid for privately consumed goods and services. Individuals who do not consume the taxed goods, and therefore do not impose external costs on others or receive user benefits, do not have a tax burden. In contrast, the burden of the income tax is not directly related to any external cost or specific government expenditure benefit.

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* See James Davies, France St-Hilaire, and John Whalley, "Some Calculations of Lifetime Tax Incidence," The American Economic Review, September 1984, p. 633.

Finally, as a matter of tax policy, we should neither accept nor reject a single provision of a comprehensive tax reform package on the basis of its distributional impact considered in isolation. As the Administration has consistently emphasized, attention should be focused on the distributional effects of the package as a whole. If consideration of the package as a whole suggests its distributional effects are inappropriate, there are a number of ways in which the package could be tailored to alter these effects.

Tax Treaty, GATT, and Related Issues

Tax Treaties. Application of the anti-avoidance rules of the proposal to certain foreign persons who are not currently subject to U.S. income tax could violate the business profits article of numerous income tax treaties that the United States has entered into with foreign countries, including treaties with Canada, France, Germany, Japan, and the United Kingdom. Generally, the business profits article of an income tax treaty prohibits one treaty country from taxing the business profits derived by a resident of the other treaty country unless such profits are attributable to a permanent establishment in the first treaty country.

GATT and Related Issues. Denial of an income tax deduction to the payor of a tariff would raise issues under the General Agreement on Tariffs and Trade (GATT). Article II of the GATT prohibits the imposition of tariffs in amounts higher than those agreed to in international negotiations. In addition, it could be argued that the proposal nullifies or impairs the benefits of tariff concessions granted to other countries.

If the proposal were found to violate the GATT or to nullify or impair benefits under the GATT, the United States would be expected to offer compensation to those countries which were adversely affected. Compensation would normally be in the form of reduced duties. If the United States did not offer adequate compensation, other countries would be entitled to retaliate against U.S. exports. Reduced duties on imports into the United States or increased foreign duties on U.S. exports would result in reduced sales and income for U.S. producers.

Even if the denial of a deduction for the payment of tariffs were found not to violate the GATT, the proposal might have a detrimental effect on foreign trade. Other countries, most of which allow tariffs to be deducted for purposes of measuring taxable income, could respond to adoption of the proposal by adopting comparable provisions. Because most of our trading partners have both higher tariffs and higher income tax rates than we do, U.S. exports could be disproportionately affected by such retaliation.

Proposal to Increase Excise Tax Rate on Wine

Background

Under current law, different rates of Federal excise tax are imposed on different categories of wine. The different categories are determined by the alcohol content and carbonation of the wines. Specifically, the schedule of Federal excise taxes on wines is as follows: $0.17 per gallon on still wines containing not more than 14 percent alcohol; $0.67 per gallon on still wines containing more than 14 percent and not more than 21 percent alcohol; $2.25 per gallon on still wines containing more than 21 percent and not more than 24 percent alcohol; $2.40 per gallon on artificially carbonated wines; and $3.40 per gallon on champagne and other sparkling wines. The rate of Federal excise tax on beer is $0.29 per gallon (a lower rate applies to certain small brewers). Most beers contain between 3 percent and 5 percent alcohol. The rate of Federal excise tax on distilled spirits is $12.50 per proof gallon.

Adjusted for differences in alcohol content, most still wines are subject to a substantially lower rate of Federal excise tax than beer and distilled spirits. For example, the same amount of alcohol is contained in one gallon of distilled spirits containing 50 percent alcohol; 12-1/2 gallons of beer containing 4 percent alcohol; 2-1/2 gallons of still wine containing 20 percent alcohol; and 4 gallons of still wine containing 12-1/2 percent alcohol. The respective Federal excise taxes on these beverages are $12.50 on the distilled spirits; $3.63 on the beer; $1.68 on the still wine containing 20 percent alcohol; and $0.68 on the still wine containing 12-1/2 percent alcohol.

Description of the Proposal

Under the Chairman's Plan, the rate of Federal excise tax on still wines containing not more than 21 percent alcohol would be increased to the Federal excise tax rate currently imposed on beer (on an alcohol content equivalence basis). Our preliminary estimate is that the proposal would raise Federal revenues by approximately $1.5 billion over fiscal years 1986-1991.

Discussion

As discussed earlier, a principal justification for imposing a Federal excise tax on wine and other alcoholic beverages is that the consumption of alcoholic beverages produces social costs not reflected in their market price. This rationale would suggest that the amount of tax should bear a relationship to the amount of alcohol contained in the beverage and that, after adjustment for differences in alcohol content, the tax rates on different alcoholic beverages should not be widely dissimilar.

The external social costs resulting from the consumption of alcoholic beverages may, however, vary depending upon the type of alcoholic beverage. To the extent there is clear evidence of such variance, some differences in excise tax rates may be appropriate.

Proposal to Adjust Federal Excise Tax Rates to Reflect Price Changes

Background

Under current law, the Federal excise taxes on alcoholic beverages, tobacco products, gasoline, diesel fuels, special motor fuels, and aviation fuels are based on the quantity of goods sold, rather than on the value of the goods sold. The tax rates are not adjusted for inflation.

Description of Proposal

The Chairman's Plan would provide for the adjustment of Federal excise tax rates on alcoholic beverages, tobacco products, gasoline, diesel fuel, special motor fuels, and aviation fuels to reflect changes in prices. The rates would not, however, be permitted to fall below the levels of current law. The proposal would raise Federal revenues by approximately $9.7 billion over fiscal years 1986-1991.

Discussion

As noted above, we believe that excise taxes may be justified to internalize external costs associated with producing or consuming the good, to cover government benefits to the users of the good, or to raise revenue with minimal distortion of economic behavior. Setting excise tax rates at a level that will achieve the intended goal of the tax requires identification and measurement of associated external costs or user benefits, as well as the responsiveness of consumers of the good to price (and therefore excise tax) changes.

These are not simple tasks, nor are they free of controversy about the proper definition and measurement of associated costs and benefits. Although any inflation rate adjustment will provide an imperfect means of correcting excise tax rates for changes in costs or benefits associated with the use of taxed goods, we believe that the alternative of having fixed rates slowly eroded by inflation is on balance undesirable. We thus support the Chairman's proposal.

As inflation has occurred and the prices of taxed goods have tended to rise, the amount of unit based (as opposed to value based) Federal excise taxes has fallen, both in constant dollar terms and as a percentage of the price of the goods. The decline in the rate of Federal excise taxes in constant dollar terms has been particularly pronounced in the case of excise taxes on alcoholic beverages. Although the Federal excise tax on distilled spirits was increased in 1985 from $10.50 per proof gallon to $12.50 per proof gallon, the rate had not previously been increased since 1951. Similarly, the Federal excise taxes on beer and wines have not been increased since 1951. If the excise taxes on these products had increased by the same percentage as consumer prices (314 percent), the excise taxes on distilled spirits, beer, and wine (containing not more than 14 percent alcohol) would have risen between 1951 and 1985 from $10.50 to $43.48 per proof gallon in the case of distilled spirits; from $0.29 to $1.20 per gallon in the case of beer; and from $0.17 to $0.70 per gallon in the case of wine.

The Chairman's Plan does not describe the manner in which Federal excise tax rates would be adjusted to reflect price changes. Such adjustment could be made by changing to an ad valorem basis for the taxes, so that they reflect the price of the products sold rather than the quantity of the products sold. Alternatively, the adjustment could be made by leaving the basis of the tax unchanged and periodically adjusting the rate of tax by an appropriate price index. We recommend the latter alternative. Changing to an ad valorem basis would require significant changes in administrative practice and raise compliance problems, for example, through the manipulation of intercompany transfer prices.

Conclusion

If sufficient base-broadening measures are not adopted, and if the President's tax reform objectives are otherwise met, the Administration could support excise and related tax proposals as part of a revenue-neutral tax reform bill, provided that a justification exists for increasing the level of the particular tax. As I have indicated in my testimony, the factors that may justify an increase in particular excise taxes are the existence of external costs associated with the production or consumption of the taxed good or service, the function of the tax as a surrogate user fee for goods or services supplied by the Federal government, and the fact that a particular excise tax may cause minimal distortion of economic behavior where demand for the taxed good is relatively unresponsive to changes in price.

Appendix A

Estimated Federal Excise Tax Collections for Fiscal Year 1986

General Fund Revenues	$ Millions
A. Alcohol Excise Taxes	
1. Distilled spirits	4,110
2. Wines	276
3. Beer	1,605
4. Alcohol occupational taxes (brewers, dealers)	21
Refunds	-124
Total	5,888
B. Tobacco	4,609
C. Manufacturers' Excise Taxes	
1. Gasoline	1
2. Firearms, shells and cartridges	92
3. Pistols and revolvers	24
4. Bows and arrows	9
5. Gas guzzler	58
6. Windfall profit	4,161*
Refunds	-90
Total	4,255
D. Miscellaneous Excise Taxes	
1. General and toll telephone and teletype service	2,327
2. Wagers taxes, including occupational taxes	7
3. Employee pension plans	14
4. Tax on foundations	127
5. Foreign insurance policies	80
Refunds	-20
Total	2,535
E. Other	153
Subtotal, General Fund	17,440
Trust Fund Revenues	
F. Highway Trust Fund	
1. Gasoline	8,730
2. Trucks, buses, and trailers	1,198
3. Tires, innertubes and tread rubber	251
4. Diesel fuel used on highways	2,618
5. Use-tax on certain vehicles	406
Refunds	-180
Total	13,022

G.	Airport and Airway Trust Fund	
	1. Transportation of persons	2,607
	2. Waybill tax	144
	3. Tax on fuel	114
	4. International departure tax	94
	Refunds	-5
	Total	2,954
H.	Aquatic Resources Trust Fund	203
I.	Black Lung Disability Insurance Trust Fund	546
J.	Inland Waterway Trust Fund	51
K.	Hazardous Substances Trust Fund	427
	Subtotal, Trust Funds	17,203
	Total Excise Taxes	34,643

Office of the Secretary of the Treasury — April 17, 1986
Office of Tax Analysis

Note: Detail may not add to totals due to rounding.

* This estimate was based on a forecast of oil prices made in December for the FY 1987 budget. The forecast for calendar year 1986, for example, was $24.70 a barrel. At a price below $16.50 a barrel, there would be no windfall profit tax liability.

Appendix B

Estimated Customs' Duties for Selected Commodity Groups for Calendar Year 1985

	$ millions
Food	473
Alcoholic beverages	127
Tobacco	64
Crude oil & petroleum products	213
Chemicals	306
Pharmaceuticals	29
Tires	73
Plywood	41
Paper	47
Textiles yarns and fabrics	494
Glass	192
Iron & steel mill products	492
Non-ferrous metals	75
Metal manufactures	253
Machinery	2,861
Transportation equipment	1,785
Apparel	3,028
Footwear	572
Scientific instruments	186
Toys and games	187
Total	11,498

Office of the Secretary of the Treasury April 14, 1986
Office of Tax Analysis

STATEMENT OF HON. MITCH McCONNELL, U.S. SENATE, STATE OF KENTUCKY

Senator McCONNELL. Thank you very much, Mr. Chairman. I know you have many witnesses, and you will be pleased to know that I will be quite brief.

The CHAIRMAN. Thank you.

Senator McCONNELL. First I want to thank you for having this hearing. At the request of myself and others, you agreed to do that, and I very much appreciate that as well as a variety of other occasions during the past 1½ years during which you have offered me excellent advice.

I would like to have my entire statement inserted in the record, if I may, Mr. Chairman.

The CHAIRMAN. Without objection.

Senator McCONNELL. Let me just summarize by making that point that when one thinks of Kentucky you typically think of four things: You think of tobacco, you think of coal, you think of bourbon, you think of horses. Three of the four of those industries are devastated by the proposal to eliminate the deductibility of excise taxes.

First, in terms of coal, in the coalfields of my State there are 40,000 persons employed in coal production, and perhaps that many again who provide materials, equipment, and services to the industry.

Recent studies show that nearly 6 percent of the total personal income in Kentucky can be attributed to the coal industry. And yet, the future does not look particularly bright.

Nationwide there are 60,000 workers whom the coal industry can no longer support. Since 1981, coal exports have declined by 27 percent, with the Department of Commerce forecasting continued increases in coal imports.

The reality, especially in light of falling oil prices, is that the coal industry is faced with a future of economic challenge.

It is in this context, then, that the committee is considering eliminating the deductibility of excise taxes for the coal industry. This action would result in new tax liability for the industry, exceeding $1 billion over the next 5 years. This is an effective increase in the black lung excise tax of 54 percent.

In an economic environment where being competitive is everything, that tax increase is tantamount to putting a ball and chain around America's coal companies.

Not surprisingly, and we have already heard reference to this, the tobacco industry would be affected by the proposed changes similarly. In Kentucky 150,000 depend on this industry to earn their living. If you eliminate deductibility for the cigarette manufacturer, you in effect increase by at least half the excise tax on a package of cigarettes. It is the consumer who will pay this $6 billion in extra taxes, and the low income consumer who will feel the cost most acutely.

Kentucky, Mr. Chairman, is also the largest producer and bottler of distilled spirits in the Nation. Nearly 13,000 Kentuckians work in the distilled spirits industry, which contributes over $400 million per year in payroll and profits to the State's economy.

Incredibly, nearly 40 percent of the retail price of a typical bottle of spirits sold in Kentucky can be attributed to taxes. The Federal portion of that alone is over 28 percent. And eliminating deductibility increases the tax on spirits at least another 50 percent.

The result will be an increase by at least one-fourth in price, a drop in demand, and a greater number of Kentuckians unemployed.

Those are the only arguments I will make, Mr. Chairman. You are going to hear from a whole lot of witnesses who are going to make a whole lot of points about this proposal. But from a Kentucky perspective, and that is my principal reason for being here this morning, this discussion about the elimination of deductibility for excise taxes is absolutely devastating, and I hope the committee will reconsider inclusion of that provision in the final form of tax revision.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Chafee.

Senator CHAFEE. No questions. I want to thank the Senator.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. No questions.

The CHAIRMAN. Senator Long.

Senator LONG. You said you hope the committee will reconsider. We haven't voted on it yet.

Senator MCCONNELL. I know you haven't. We hope it won't get that far.

Senator LONG. So, we will consider your argument, as well as the arguments on the other side of it. Thank you for your statement.

Senator MCCONNELL. Thank you, Senator Long.

The CHAIRMAN. Thank you very much, Mitch.

Senator MCCONNELL. Thank you, Mr. Chairman.

The CHAIRMAN. Has Senator Eagleton arrived yet?

[No response.]

The CHAIRMAN. If not, let us move on to a panel of Tylee Wilson, Carlton Blalock, Matthew Myers, and Gerry Oster.

Mr. Wilson, go right ahead.

Again, let me indicate to all of the witnesses, except for the Secretary of the Treasury, that we have asked witnesses to hold their statements to 5 minutes, including Senators. Your statements will be in the record in their entirety, but I will hold you pretty firmly to the 5-minute oral presentation.

[The written prepared statement of Senator McConnell follows:]

Statement By
SENATOR MITCH McCONNELL

Before the
Committee on Finance
United States Senate

April 21, 1986

Public Hearing on Chairman's Tax Reform Proposal
Relating to Excise Taxes

Mr. Chairman, custom dictates that I begin by thanking you for scheduling this hearing. But my appreciation for you taking time to discuss the excise tax and tariff issues in the tax reform proposal now before the Committee, goes far beyond custom. There is perhaps no state in America more affected by these excise tax provisions than Kentucky, and it is on behalf of the residents of my state that I thank you for focusing on a topic that so directly affects their lives.

By its very nature, Mr. Chairman, the process of forging a tax reform plan involves choosing winners and losers. While I recognize that it is impossible to agree on comprehensive reform provisions that make everyone happy, the goal of the legislative process should be to produce legislation based on equitable economic assumptions.

I have asked for this time, therefore, to express my grave reservations about proposals which would effectively increase excise taxes for American industry and ultimately millions of American consumers--consumers for products whose diversity ranges from cigarettes to gasoline, distilled spirits to tires, diesel fuel to coal, airline tickets to telephone services.

The Witness List before you represents an exhaustive catalogue of the industries affected. Before the day is out this Committee will hear over and over again the arguments, based on fundamental principles of equitable tax policy, against ending the deductibility of excise taxes and tariffs, or accepting further increases in these taxes.

Those that follow will no doubt emphasize the regressive nature of excise taxes, the disregard for fundamental and equitable principles of accounting represented by the elimination of deductibility for excise taxes and tariffs, and the serious Constitutional questions raised by nondeductibility. While outlining these arguments is important, I am here this morning for a different reason. If this Committee chooses to accept the excise tax proposals now before them, I want you to know in the clearest possible terms the consequences for the Commonwealth of Kentucky.

In the coal fields of my state there are 40,000 persons employed in coal production, and perhaps that many again who provide materials, equipment and services to the industry. Recent studies show that nearly 6% of total personal income in Kentucky can be attributed to the coal industry. And yet the future does not look bright. Nationwide there are 60,000 workers who the coal industry can no longer support. Since 1981 coal exports have declined by 27% with the Department of Commerce forecasting continued increases in coal imports. The reality, especially in light of falling oil prices, is that the coal industry is faced with a future of economic challenge.

It is in this context, then, that the Committee is considering eliminating the deductibility of excise taxes. This action would result in new tax liability for the coal industry exceeding $1 billion over the next five years. That is an effective increase in the Black Lung excise tax of 54%. In an economic environment where being competitive is everything, that tax increase is tantamount to putting a ball and chain around America's coal companies.

Not surprisingly, the tobacco industry would be affected by the proposed changes similarly. 150,000 Kentuckians depend on this industry to earn their living. If you eliminate deductibility for the cigarette manufacturer you, in effect, increase by at least half the excise tax on a package of cigarettes. It is the consumer that will pay this $6 billion in extra taxes and the low-income consumer that will feel the cost most acutely.

Kentucky, Mr. Chairman, is also the largest producer and bottler of distilled spirits in the nation. Nearly 13,000 Kentuckians work in the distilled spirits industry which contributes over $400 million per year in payroll and profits to the states's economy. Incredibly, nearly 40% of the retail price of a typical bottle of spirits sold in Kentucky can be attributed to taxes. The Federal portion of that alone is over 28%, and eliminating deductibility increases the tax on spirits at least another 50%.

The result will be an increase by at least one-fourth in price, a drop in demand, and a greater number of Kentuckians unemployed.

There are, of course, in addition to the industries mentioned, residents of Kentucky that earn their living in the rubber, airline, gasoline, communications, and transportation industries. If this Committee approves an excise tax increase of $75 billion these workers, and the consumers who purchase their products, will bear the cost.

Mr. Chairman, I came to the United States Senate wanting to support tax reform. And while I continue to believe tnat the American taxpayer deserves something better than the current tax code, I am not yet convinced that Congress is moving in that direction. That is not to say, Mr. Chairman, that there is not much in your proposal that I could support--there is.

What I cannot explain to my constituents is paying for tax reform with an unprecedented increase in the most regressive taxes of all. We began this debate well over a year ago because it was evident that U.S. taxpayers believe the tax code is unfair. In the final analysis, the tax reform bill this committee reports will be judged primarily by one standard--the standard of equity. And I would be less than candid if I did not tell you that from no perspective can the nondeductibility and possible increase of excise taxes be viewed as fair by those I represent.

STATEMENT OF J. TYLEE WILSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, R.J. REYNOLDS INDUSTRIES, INC., WINSTON-SALEM, NC, ON BEHALF OF THE TOBACCO INDUSTRY

Mr. WILSON. Thank you, Mr. Chairman.

My name is J. Tylee Wilson. I am chairman and chief executive officer of R.J. Reynolds Industries, which is the parent company of R.J. Reynolds Tobacco Co., Nabisco Brands, Del Monte Corp., Kentucky Fried Chicken, and Heublein, Inc.

I welcome the opportunity to appear before you not only as a spokesman for my company but as the representative of the Tobacco Institute.

As you know, Mr. Chairman, I have worked actively to promote tax reform. I believe strongly in the need for lower rates and in the desirability of making the tax system fairer, more neutral, and less burdensome on low income people.

Let me state our position on the excise tax proposals:

I am unequivocally opposed to the nondeductibility of excise taxes and any indexing of those taxes to prices, or indexing them in any other manner, because I find such a proposal insidious and discriminatory. These proposals, in our opinion, do not belong in a tax reform bill. In our judgment they violate every canon of tax reform laid down by the President and recently reiterated by the Secretary of the Treasury. They discriminate against one taxpayer over another; they discriminate against one consumer over another; they discourage one form of consumption over another; and they discourage one form of investment over another.

Other witnesses have discussed or will discuss the antibusiness, anticonsumer, and inflationary aspects of the excise tax provisions. They will undoubtedly elaborate on the regressive nature of excise taxes in general and of treating them as nondeductible, and indexing them in particular. I agree with those assertions and will not elaborate on the reasons underlying them.

So I speak to you as a businessman, and I appear before you with years of experience in the marketplace. Excise taxes are a cost of doing business. The nondeductibility and indexing provisions will result in increased costs to my company, and thus we will have no alternative but to pass along those increased costs to consumers.

My company manufactures and sells literally hundreds of products—everything from Planters Peanuts to Kentucky Fried Chicken to cigarettes. In my judgment, the only legitimate factor in any individual's decision to use any of our products is that individual's personal preference. The point is that all of our products are legal, and they are legitimate.

My company and the tobacco industry deserve the same fair treatment under our laws as any other business activity.

I urge you to consider the staggering tax burden already imposed on tobacco and spirits. For example, under present law more than 75 percent of the total net income of our tobacco company is paid to the Federal Government in the form of income, excise, and other taxes. Moreover, we believe that for millions of American consumers these excise tax proposals would wipe out substantially any benefit from the proposed income tax rate reduction. The indexing proposal by itself would declare that consumers of our products should be treated differently and subjected to steady, relentless tax increases without any further congressional determination of the appropriate tax rate.

In 1985 our tobacco company alone paid $450 million in Federal income taxes, and these proposals would increase that burden by another $500 million. Thus, even assuming the corporate income tax rate will be reduced to 35 percent, the effective income tax rate for our tobacco company would rise to 82 percent, and for our spirits company 168 percent. Moreover, if we consider our total Federal income, excise, and FICA tax burden, the effect is almost as if the Government owned the assets of the businesses. Under such circumstances, substantial price increase would have to be initiated, with the inevitable result of such action being a significant decline in consumption, followed by a reduction of tax revenue, and a devastating impact on our consumers, shareholders, suppliers, employees, and finally the American farmer.

So, I urge you to reject the excise tax, nondeductibility, and indexing proposals.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

Mr. Blalock.

[The prepared written statement of Mr. Wilson follows:]

STATEMENT

OF

J. TYLEE WILSON

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

R. J. REYNOLDS INDUSTRIES, INC.

BEFORE

THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

WASHINGTON, D.C.

APRIL 21, 1986

Mr. Chairman and Members of the Committee:

I am J. Tylee Wilson and I am Chairman and CEO of R.J. Reynolds Industries. RJR is one of the largest U.S. consumer products companies and manufactures various tobacco, food, and beverage products. Our operations include R.J. Reynolds Tobacco Company, Nabisco Brands, Inc., Heublein Inc., and Kentucky Fried Chicken Corporation. We market our products worldwide and in 1985 had net sales of $16.6 billion. R. J. Reynolds Industries employs 147,500 people worldwide of which 86,800 are employed in the United States.

RJR is, by any measure, a high effective rate taxpayer. In fact a recent study by Citizens For Tax Justice pointed out that from 1981 to 1984 RJR was one of the highest effective rate taxpayers among the companies surveyed. Our 1985 effective corporate tax rate was 46%.

It should, therefore, not be surprising that as early as December 1984, we expressed our support for the Administration's tax reform proposals in a letter to former Secretary Regan. Since that time we have taken a public stand in support of Administration efforts to ensure that all classes of taxpayers are treated in a fair and equitable manner. We are still committed to fundamental tax reform arrived at by reducing or eliminating costly tax concessions to favored industries, removing individuals below the poverty line from the tax rolls and taxing all income at the lowest possible rate. We agree with Secretary of the Treasury Baker's statement that:

> "... the tax system must not be used to favor one taxpayer over another, to favor one industry over another, to favor one form of consumption over another, or to favor one investment over another."

We remain hopeful that your Committee will produce a bill which achieves such meaningful tax reform.

As you may know, R. J. Reynolds, like most tobacco companies, is engaged in many consumer businesses. With this broad spectrum of activity, some consumers find a number of our products attractive and others may reject one or more of our product lines. In our society that is the right and privilege of a consumer. Whether or not one is favorably disposed to a product is a matter of individual choice. Two of our businesses, tobacco and spirits, have in this regard generated a great deal of controversy. What I wish to stress is that regardless of one's personal views -- whether or not one is favorably disposed to purchase and consume those products -- their manufacture, distribution, and sale represent a legitimate business endeavor. As such, my company deserves the same fair treatment under our laws as any other business activity.

I recognize some members of this Committee may disagree with that, and, indeed, some may even strive to eliminate these businesses. We are all entitled to our personal views and within the law and the bounds of propriety we are entitled to strive to fulfill them. I submit, however, that one should not attempt to achieve that objective through manipulation of the tax code. All legitimate and legal business activities are entitled to fair and equal treatment. In my judgement that would not be the treatment accorded to the tobacco and spirits industries if the proposal is adopted to disallow deductions for excise taxes and tariffs paid, to link excise taxes to future price increases, and to increase the excise tax on wine to the alcohol equivalent of beer. These proposals are completely contradictory to efforts to achieve fairness in our tax codes.

The Committee is considering a number of costly business tax concessions. A frantic search for new revenues has developed. Accordingly, we see rather than tax reform, a discriminatory redistribution of the tax burden by imposing a tax increase through the nondeductibility and indexing of excise taxes.

The deduction of federal excise taxes is not a loophole. Excise taxes and tariffs, which are taken into income, are costs of doing business and, like any other costs, should remain a deduction. If the Committee should break through this policy barrier and disallow legitimate business deductions, no business cost would be immune from attack. Once such a tax policy exception is established, it would become easier to extend the exception to other areas.

Excise taxes are deductible for financial accounting purposes and should remain deductible for tax purposes. Let me reinforce that point with a brief look at how the process works in the cigarette industry.

The excise tax is imposed on a pack of cigarettes at the time it leaves our distribution center. It normally takes five weeks -- from the time the cigarettes leave our factory -- until RJR actually receives payment from the customer for the product. Meanwhile, we are required to remit the tax to the U.S. Treasury.

In most cases, we have not at that time received payment from the customer. Accordingly, we must pay the tax from our internal funds. This tax prepayment increases our working capital requirements by millions of dollars. Those increased costs are legitimate business expenses.

Excise taxes are included as a cost to be recovered from our sales of the taxed product. Those sales proceeds are included as gross income subject to tax. Clearly, gross income must be offset with a deduction for excise taxes paid in order to calculate net income. To do otherwise, an unprecedented first step would be taken towards taxing the gross revenues of American business. Such a step would violate the traditional concept of income as defined in the tax code and, according to our lawyers, raise serious Constitutional questions. In addition, these excise tax revisions violate a major objective of tax reform -- fairness.

The excise tax nondeductibility and indexing provisions will increase prices paid by consumers. The regressive nature of the proposal places a disproportionate amount of that increase on the lower income taxpayers. According to a recent deSeve Economics study, these provisions would "wipe out almost half of the income tax reduction promised" by the tax reform package and the effect by income class would be very uneven. Consumers with less than twelve percent of total income would pay 23% of the increased excise taxes. Conversely, taxpayers with earnings above $100,000, who receive fourteen percent of all incomes, would pay only six percent of the total increased excise taxes. While consumers with incomes under $10,000 appear to be getting a 77% reduction in income taxes under the proposal, the deSeve study shows that when excise tax increases are factored in, these consumers get only a thirteen percent reduction. In contrast, higher income taxpayers with income over $200,000 get to keep virtually all the cuts offered in the proposal.

In addition, a 1985 deSeve study on the distributional impact of tobacco taxes showed that the excise taxes on tobacco were the most regressive of all the taxes studied. (Included in the study were federal personal income taxes, social security payroll taxes, gasoline excise taxes, alcoholic beverage excise taxes and tobacco excise taxes.) For consumers with incomes of less than $20,000 per year, the tobacco excise tax burden imposed on them was 38.9%, while the federal income tax burden was only 9.6%.

If Congress wants to raise additional revenue, then it should be a broad-based tax mechanism and not one limited to a small number of products which are already heavily taxed. It is respectfully submitted that such a tax should be addressed in a public forum and not implemented through this "back door" approach.

There has been some debate about whether or not manufacturers of excise taxed products will simply increase prices to offset that additional cost, or whether some or all of the tax will be absorbed by the company. Let me assure you, as the CEO of R.J. Reynolds, that decision will be a difficult and painful one.

The effect of the Chairman's proposals would be to increase the tax burden of RJR significantly. If RJR attempted to absorb additional liability the result would be disinvestment of the company's shareholders. The return on the capital invested in the company would drop below the cost of such capital causing the return on the shareholders' equity to decline, with a concomitant drop in the company's stock price. Further, the company would not be generating sufficient after-tax earnings or cash flow to continue the level of dividends and meet its capital reinvestment needs to remain competitive.

The ultimate result would be severe curtailment of business activity which would adversely affect not only the company's shareholders but its employees as well. The only recourse to the company to attempt to avoid these consequences would be to pass the additional tax burden on to the consumer through increased prices.

Increasing prices, however, is not a solution. Even though it would minimize adverse effects in the short term, it would seriously impair long-term prospects for the businesses. Over time the same adverse consequences would result to our employees, shareholders and others who depend on these businesses for their livelihood.

The average consumer price of a pack of cigarettes or a bottle of liquor, when accompanied by distribution markups by wholesalers and retailers, would increase significantly. However, the excise tax proposals make it difficult to raise cigarette and spirits prices because of the excise tax indexing provision. It is not yet clear how the indexing proposal would work. If one assumes the excise tax will be indexed to a cigarette and spirits price, once these prices increase so will the tax. Those increased excise taxes would be nondeductible.

Our predicament is further compounded by the realities of the marketplace. We have found that the prices of our products are becoming more income elastic. Any time prices are increased, particularly on items which constitute discretionary purchases, the obvious happens -- consumption goes down. In the case of cigarettes, the 1983 excise tax increase resulted in a market decline of six percent. It has never recovered. The spirits industry, which received a 19% excise tax increase last October, is also off six percent to date and it is not expected to recover. Furthermore, if excise tax proposals were enacted, we estimate further severe decline in both spirits and tobacco consumption. In the case of spirits alone consumption could decline as much as forty percent.

It seems clear from these figures that marketplace realities will cause significant shortfalls in tax revenues projected to be raised by these proposals ... not only for the federal government but for state and local governments as well. In addition, the indexing proposals will result in a permanent preemption of an important source of state tax receipts. Governor Lamm highlighted this problem last month in a letter to Senator Packwood on behalf of the National Governors Association when he stated that the excise tax indexing proposal "would preempt over

$13 billion of these revenues over 5 years".

Five years ago the Congress established an important principle of taxation-adjustment for inflation. Congress decided that tax burdens should not increase with price changes; that the taxpayer should be protected against paying a double penalty for inflation by moving into a higher tax bracket when he realized a purely nominal increase in income; that government should not enjoy a tax windfall as a result of inflation; and that the tax system should not operate to magnify inflation. The excise tax proposals would reverse these principles. Consumers of certain products would be treated differently, and subjected to steady tax increases without any further Congressional determination of the appropriate tax rate.

A third excise tax provision, which would increase the excise tax on wine to the alcohol equivalent of beer, would increase the tax on wine by an average of 300%. That provision alone would increase our excise tax payments by about 400% even without the indexing or nondeductibility provisions. We believe that the ultimate cost to consumers might be increased significantly. As a result, our sales volume could decrease by as much as seven percent.

Both industries already bear more than their fair share of the nation's tax burden. As you are well aware, in 1984 the spirits tax was increased by $2.00 per proof gallon, and just last month the 16-cent cigarette excise tax, which was to sunset at eight cents, was extended permanently as part of the reconciliation package. As a result of state and federal excise taxes on cigarettes and spirits, those products are among the most heavily taxed products in the United States. On the average, taxes imposed by various levels of government make up more than fifty percent of the price of a pack of cigarettes. A bottle of spirits bears almost the same burden in federal, state and local excise taxes.

It is no wonder we constantly hear that the government believes additional revenues can always be raised through taxing tobacco and spirits.

Surely some consideration should be given to one of our principal suppliers -- the farmer. As mentioned above, adoption of the excise tax proposals will result in an inevitable price increase for tobacco products. I have indicated that as prices go up, sales go down. What should also be noted is that as sales drop our purchases of tobacco leaf will decline. The result will be an additional economic burden for the hundreds of thousands of small tobacco farmers. The agricultural economic consulting firm, Schnittker Associates, concluded last month that if the nondeductibility provisions are adopted tobacco growers alone could lose well in excess of $100 million per year because of reduced sales.

At a time when some companies are paying no federal income tax, surely some way can be found to equalize the burden on corporations like ours which pay substantial amounts of federal income and excise taxes, unless the primary reason for the excise tax proposals is to undercut the tobacco and spirits industries. In view of our present excessive federal tax burden, we view these proposals as punitive and confiscatory-designed to discourage consumption of selected products. The mandate of tax reform should be to more evenly distribute the federal income tax burden. The excise tax nondeductibility and indexing proposals would have the opposite effect and injure our shareholders, employees, suppliers, and consumers and eventually result in reduced federal tax revenues.

I urge the Committee to delete the excise tax proposals.

STATEMENT OF T. CARLTON BLALOCK, EXECUTIVE VICE PRESIDENT, TOBACCO GROWERS ASSOCIATION, RALEIGH, NC

Mr. Blalock. I am T.C. Blalock, executive vice president of the Tobacco Growers Association of North Carolina. On behalf of more than 100,000 families in our State who derive some income from tobacco, I want to express strong opposition to certain provisions of this bill.

An analysis of this bill by researchers in the Department of Economics at NC State University concluded that ending the deductibility of the excise tax and indexing it in the future would shortly result in an increase in the cost of a pack of cigarettes of about 17 percent, assuming an average price of $1.

These same researchers estimate the price elasticity of demand for tobacco may be as high as −.5. Thus, a 17-percent increase in the price of cigarettes could translate into an 8.5-percent drop in sales.

Prior experience has shown that it is the grower, not the manufacturer, who winds up being the biggest loser when sales decline. Manufacturers simply pass their increased costs along to the consumer, and further diversify, if necessary, to maintain stockholder profits, as they should. But as growers, we know that a drop in sales means they need less of our tobacco, and the impact will be magnified for us in the marketplace for the next 2 years.

This is true, because manufacturers normally keep between a 2 and 3 years' supply of tobacco on hand in order to age it properly. But with a drop in sales of 8.5 percent, they suddenly find themselves with at least 17 to 25 percent more tobacco than they will need over the next 3 years. If they adjust that inventory over a 2-year period, we will experience quota cuts of at least 12.5 percent for each of those 2 years.

In North Carolina this would mean a reduction in income to tobacco farmers in excess of $100 million for each of those 2 years, or over $222 million in the second year.

We grow approximately 43 percent of all the tobacco grown in the United States. Assuming other types would be affected similarly, one could project a reduction in income to U.S. tobacco farmers by the end of the second year of $516 million.

Assuming a newly generated dollar moves up to 5 times through a ripple effect on the general economy, we could see a negative economic impact of $2.58 billion in the 20 States in which tobacco is grown.

We are also concerned over the provisions in the bill regarding excise taxes on fuel. Other than labor, fuel costs are the largest single item of cash expenses involved in producing flue-cured tobacco, representing almost 20 percent of operating inputs.

Tobacco farmers recognize that to be competitive in the world market we had to lower the price of our tobacco. We have done this through the recently enacted tobacco reform legislation by reducing price supports over 16 percent. Our association strongly supported this bill. We want to express to you, Senator Packwood, and other members of your committee, our sincere appreciation for the significant role you played. However, for farmers to survive under these lower prices, we have got to lower production costs. This bill, unfortunately, would have the opposite effect.

Quota reductions generally result in smaller operating units and higher costs of production. Our flue-cured quotas have already been cut almost 50 percent in the last 10 years. Further cuts of the magnitude we are talking about would have a serious impact on our ability to compete in a world market.

Because of quota cuts and increasing assessments, thousands of tobacco farmers have been forced to leave the farm and seek other employment. This bill will speed up that movement. It is not a good time to be looking for off-farm employment. For many, their only alternative will be some form of public assistance.

Let me close by responding to those who continually suggest that the way to solve the problem of the tobacco farmer is to get him to grow other crops. Just last week another researcher suggested that tobacco farming be treated like any dying industry, and alternative sources of income be found, and, specifically suggested that we get them into growing tomatoes, strawberries, and flowers.

The problem with that approach is, I can take less than 5 percent of the acres we now devote to tobacco and completely break the market for any one of those commodities.

We have made great strides in diversifying our agriculture, but the truth remains that there are no alternative crops available that in the foreseeable future can replace the annual farm income of almost $1 billion that we derive from tobacco in North Carolina. We do a disservice to the public to continue to perpetuate that myth.

Thank you for the opportunity to express our views on this bill. We ask you to delete those provisions that would increase the Federal excise taxes on cigarettes, fuel, and tires, and make them nondeductible for Federal income tax purposes.

Thank you, Senator.

The CHAIRMAN. Thank you, sir.

Mr. Myers.

[The prepared written statement of Mr. Blalock follows:]

STATEMENT
OF
T. CARLTON BLALOCK
EXECUTIVE VICE PRESIDENT
TOBACCO GROWERS ASSOCIATION OF NORTH CAROLINA, INC.
BEFORE
COMMITTEE ON FINANCE
UNITED STATES SENATE
APRIL 21, 1986

I am T.C. Blalock,Executive Vice President of the Tobacco Growers Association of North Carolina, Inc. We are a commodity Association representing both flue-cured and burley farmers in our state. I regret that my President could not be here today but he is a tobacco farmer and is busy starting his 1986 crop.

Our Association has reviewed this proposed tax bill and the potential impact it can have on tobacco farmers. On behalf of our members, I want to express strong opposition to certain provisions, which if enacted, will have serious economic consequences for every tobacco farmer in the United States.

As I understand the intent of the bill, it would immediately increase the federal excise tax on cigarettes from 16 cents to 25 cents per pack. It would also almost guarantee that this tax would continue to rise since it would be tied to future tobacco product prices. Furthermore, the proposal to disallow the deductibility of these excise taxes as a business expense will force manufacturers and retailers to further increase their price to the consumer. Researchers in the Department of Economics at North Carolina State University have estimated that this provision could add another 10.7 cents to the cost of a pack of cigarettes, for a combined increase of 19.7 cents over the present 16 cent federal excise tax. Assuming an average price of $1.00 per pack, these changes would result in an increase in the cost of cigarettes to the consumer of almost 20 percent.

These same researchers at North Carolina State University estimate the price elasticity of demand for cigarettes may be as high as -.5. This means a 2 percent increase in price will result in a 1 percent decrease in demand. Thus, a 20 percent increase in the price of cigarettes could translate into a 10 percent reduction in sales. Most people believe that the big losers when cigarette excise taxes are increased and sales decline are the manufacturers. The truth of the matter is - and we have data from prior experience to support this conclusion - it's the grower who winds up being the biggest loser. Manufacturers simply pass the tax and other increased costs along to the consumer and further diversify if necessary to maintain profit levels for stockholders - as they should. But as growers, we know a drop in sales - for whatever reason - means manufacturers need less of our tobacco. A 10 percent drop in sales, however, means we will experience quota cuts of considerably more than 10 percent for the following two years.

Since manufacturers normally keep between two and three years supply of tobacco on hand - in order to age it properly - they will suddenly find themselves with at least 20 to 30 percent more tobacco than they will need over the next three years. If they attempt to adjust their inventory over a two year period, we'll experience quota cuts of about 15 percent for each of those two years.

In North Carolina a 15 percent cut in our tobacco quota means a reduction in income to tobacco farmers in excess of $111 million annually. We grow approximately 43 percent of all tobacco grown in the United States. Assuming other types of tobacco would be similarly affected, one could conclude that as a result of this bill, U S tobacco farmers could expect to see a reduction in income from the sale of tobacco in excess of $258 million because of the 15 percent cut in their quota. They would also experience a loss of an additional $258 million from the next 15 percent cut - or a total of $516 million in the second year. If, as the economists say, a newly generated dollar will move up to five times through a ripple effect on the general economy, we could be talking about negative economic impact of $2.58 billion in the twenty states in which tobacco is grown. Gentlemen, an economic impact of that magnitude will be felt in almost every crossroads in those states.

We are also concerned over the provisions in the bill that would increase the excise taxes on fuel and tires and also make them nondeductible for federal income tax purposes. Other than labor, fuel costs are the largest single item of cash expenses involved in producing flue-cured tobacco, representing almost 20 percent of operating inputs. Thus, anything that increases the cost of fuel to the tobacco farmer, adds significantly to his cost of production. This is of great concern to us at this particular time.

Tobacco farmers recognized that to be competitive in the world market, we had to lower the price of our tobacco. We've done this through the recently enacted tobacco reform legislation by reducing our price supports by over 16 percent. Our Association played a leading role in forging this legislative package and we strongly supported it. We want to express to Senator Packwood and other members of this Committee our sincere appreciation for the support you gave. We are aware of the significant role you played. However, for farmers to survive under these lower prices, we've got to lower production costs. This bill, unfortunately, would have the opposite effect. Quota reductions generally result in smaller operating units and higher costs of production. Our flue-cured quotas have already been cut almost 50 percent in the last 10 years. Further cuts of the magnitude we're talking about will have serious impact on our ability to compete in a world market. And, since fuel represents such a significant portion of cash expenses in a crop of flue-cured tobacco, the impact of those provisions relating to excise taxes on fuel will also be particularly detrimental to us.

I should also point out that most tobacco farmers also produce grain. Thus, any impact this bill will have on demand and prices for grain resulting from the proposed increases in excise taxes on liquor and beer, and how those taxes are treated for federal income tax purposes, will also be felt by tobacco farmers.

I'm sure this committee is aware of the regressive nature of all excise taxes. Because the percentage of total income spent on buying cigarettes falls as income rises, cigarette excise taxes are already levied at higher effective rates on the disadvantaged and those on fixed incomes than on the more affluent. Cigarette excise taxes are already more than six times the value of domestic tobacco used in these cigarettes. If this bill is enacted that ratio will more than double.

Because of quota cuts and increasing assessments levied on them to support their program, there are thousands of tobacco farmers who have been forced to leave the farm and seek other employment. This bill will speed up that movement. It's not a good time to be looking for off-farm employment. For many, their only alternative will be some form of public assistance.

Let me close by responding to those who continually suggest that the way to solve the problems of the tobacco farmer is to get him to grow other crops. Just last week, a researcher at another institution in our state suggested that tobacco farming should be treated like any other dying industry and alternative sources of income be found for these farmers. She suggested specifically that we get them into growing tomatoes, strawberries and flowers as a substitute for tobacco. The problem with that approach is, I can take less than 5 percent of the acres we now devote to tobacco and completely break the market for any one of these commodites. I've spent most of my adult working career in helping to diversify our agriculture. And we've made great strides. But there are no alternative crops available that, in the foreseeable future, can replace the annual farm income of almost $1 billion we derive from tobacco in North Carolina. We do a disservice to the public to continue to perpetuate that myth.

Thank you for the opportunity of expressing our views on this bill. On behalf of all tobacco farmers, but particularly for the approximately 100,000 families in North Carolina who derive some income from our flue-cured and burley tobacco crops, I want to ask you to delete from this bill the provisions that would increase the federal excise taxes on cigarettes, fuel and tires and make those taxes non-deductible for federal income tax purposes.

STATEMENT OF MATTHEW MYERS, STAFF DIRECTOR, COALITION ON SMOKING OR HEALTH, WASHINGTON, DC

Mr. MYERS. Thank you, sir.

My name is Matthew Myers. I am the staff director of the Coalition on Smoking OR Health.

The coalition was founded in 1982 by the American Heart Association, the American Lung Association, and the American Cancer Society.

Without commenting on any provision of the tax bill other than the cigarette excise tax provision, the Coalition on Smoking OR Health wants this committee to know that we support the cigarette excise tax provisions, and we urge the committee either to adopt those provisions or to consider an outright increase in the cigarette excise tax and the tax on smokeless tobacco.

These provisions would provide substantial new revenues and would also be an important factor in reducing future health care costs by reducing cigarette consumption.

Whether as a part of tax reform or your budget deficit reduction effort, the Coalition on Smoking OR Health urges you to takeadvantage of the dual benefits which would be realized by increasing the cigarette excise tax and the tax on smokeless tobacco.

In my testimony today I will focus on four reasons for the coalition's position.

First, increased cigarette excise taxes represent one of the most effective methods for discouraging teens from smoking, a key to our society's long-term efforts to beat lung cancer and decrease the toll of heart disease, emphysema, and chronic bronchitis.

Second, increased cigarette excise taxes are supported by a vast majority of the American public and no fewer than 44 major national organizations. No other revenue raising measure has such support.

Third, smoking costs our economy $65 billion annually. Cigarette excise taxes are one way for the Federal Government to recoup a small portion of these heavy economic losses.

Finally, this particular tax is fair. Why should the American taxpayer subsidize the operating expenses of an industry whose product kills more than 350,000 Americans each year, and whose major new users by and large are so young that they are addicted to this product before they are old enough to legally purchase it.

Let me address each issue briefly.

Point one: Cigarette prices and consumption. As you have heard, there is no disagreement that cigarette prices directly affect the number of cigarettes consumed. In a report published last fall by Harvard University, Dr. Kenneth Warner of the University of Michigan confirmed what previous studies have shown. Dr. Warner concluded that an 8-cent increase in the cigarette excise tax would prompt almost 2 million people each year to stop or not start smoking, including more than 400,000 teenagers and more than one-half million young adults.

Point two: There is widespread support for increased cigarette excise taxes. A Los Angeles Times poll released in February 1986 found that 81 percent of the American public favors the idea of higher cigarette excise taxes. Last year a Time magazine poll found that 77 percent of the American public favores increased cigarette excise taxes as the best method for raising revenue.

In addition, the Coalition on Smoking OR Health is joined by 44 other national organizations in our support for an increase in the cigarette excise tax to 32 cents per pack. These 44 organizations range from groups like the American Medical Association to the American Association of Retired Persons, from the American Public Health Association to the Children's Defense Fund, the United Methodist Church, and the YWCA.

Point three: The cost of cigarette smoking—in dollars alone, what does smoking cost us each year. In a major report issued last fall, the Office of Technology Assessment estimated that smoking-related disease and lost productivity cost a total of $65 billion annually. Medicare and Medicaid costs alone total over $4 billion each year, according to OTA. These costs, including the $22 billion annually for health care costs, are incurred by all Americans, two-thirds of whom do not smoke.

The human costs of cigarette smoking are even greater. Approximately 350,000 people die each year because of smoking-related diseases. Eighty-five percent of all lung cancer cases, the vast majority of all chronic obstructive lung disease cases, and about one-third of all heart disease related deaths are caused by smoking.

Point four: Fairness. We hear much debate about the fairness of the excise tax on cigarettes. These debates focus on three issues: Why single out cigarettes. Are these taxes unfair to the poor? Do these taxes hurt tobacco farmers? Let me address each.

Why single out cigarettes? There is a very good reason. Cigarettes are the only product—I underscore "the only product"—which are hazardous when used as intended. This statement cannot be made for any other product sold legally in the United States. If cigarettes were created today, they would be illegal.

I have just about 30 seconds left.

The CHAIRMAN. I will have to ask you to conclude, please.

Mr. MYERS. I will in just 1 minute.

The CHAIRMAN. Thirty seconds.

Mr. MYERS. Do these taxes hurt the poor? The average pack-and-a-half per day smoker pays approximately $525 per year to support his or her habit. The proposed excise tax increases would add only 42 cents per week to that cost. In addition, to the extent this tax leads to fewer smokers among the poor, and it will, they will be better off economically as well as healthwise.

Finally, I would like to address the issue raised by Mr. Blalock.

The CHAIRMAN. I have to cut you off. If I am going to hold witnesses to 5 minutes, I have to apply it to you, too. You are done.

Mr. MYERS. Thank you, sir.

The CHAIRMAN. Mr. Oster.

[The written prepared testimony of Mr. Myers follows:]

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TESTIMONY OF

MATTHEW L. MYERS

Staff Director

ON BEHALF OF

THE COALITION ON SMOKING OR HEALTH

AMERICAN LUNG ASSOCIATON
AMERICAN HEART ASSOCIATION
AMERICAN CANCER SOCIETY

Before The

SENATE COMMITTEE ON FINANCE

On

Hearings On The Excise Tax Provisions

In The Proposed Tax Reform Legislation

Monday
April 21, 1986

"CIGARETTE SMOKING IS THE SINGLE MOST PREVENTABLE CAUSE OF DEATH IN THE UNITED STATES"

My name is Matthew L. Myers, and I am the Staff Director of the Coalition on Smoking OR Health.

I am testifying today on behalf of the Coalition on Smoking OR Health and its member organizations, the American Heart Association, the American Lung Association, and the American Cancer Society. The Coalition was founded in early 1982 by these three groups to bring smoking prevention and education issues to the attention of legislators and other government officials. The Coalition on Smoking OR Health supports the excise tax provisions proposed in the draft tax reform bill as they apply to cigarette excise taxes, and we urge the Committee to adopt these provisions whether you ultimately adopt a tax reform bill and without regard to any other provisions in the tax reform bill you are now considering. These two provisions are meritorious and stand on their own as an excellent way to raise revenue while improving the public health of our nation.

We would also like to encourage the Committee to consider a straightforward increase to the cigarette excise tax. Raising the cigarette excise tax to 32 cents would provide substantial new revenues - - some $20 billion over five years - - and would also prove an important factor in reducing future Federal health care and lost productivity costs by reducing the cigarette consumption of the next generation of potential smokers. This Committee will have more than one opportunity to consider alternative sources of additional revenues in order to meet ambitious deficit-reduction targets, and the Coalition on Smoking OR health urges you to take advantage of the dual benefits which would be realized by increasing the cigarette excise tax: enhanced Federal revenues, and a reduction in the single most preventable cause of death in the United States - - cigarette smoking.

In my testimony today I will focus on four reasons for the Coalition's support of eliminating the deductibility of cigarette excise tax payments as a business expense, and of linking cigarette excise tax rates to inflation. Our first reason is that these two proposals would result in increased cigarette prices, and higher cigarette prices lead to decreased cigarette consumption, particularly among young people. Second, a broad-based coalition of support for increased cigarette excise taxes has emerged, including 81 percent of the American public. Third, smoking-related health care and lost productivity costs our economy $65 billion annually, and cigarette excise taxes are one way for the Federal government to recoup a small portion of these heavy economic losses. Finally, we do not believe it is fair that the American taxpayer should subsidize the operating expenses of an industry whose product kills more than 350,000 Americans each year and whose major activity is to seduce new, young smokers, especially minorities and women, into taking up this addictive habit.

I. Cigarette Prices and Consumption

In a report published last fall by the Harvard University Institute for the Study of Smoking Behavior and Policy, Dr. Kenneth Warner of the University of Michigan concluded that an 8 cent increase in the cigarette excise tax would encourage almost 2 million people to stop or not start smoking, including more than 400,000 teenagers and more than half a million young adults (ages 20 - 25). Increasing the cigarette excise tax to 32 cents would deter more than 800,000 teenagers from smoking, and a total of 3.5 million Americans would forgo the habit.

The two excise tax provisions proposed in the tax reform package would have the effect of increasing cigarette prices. Historically, the cigarette industry has passed on similar operating cost increases to the consumer. Therefore, these proposed excise tax changes would have significant health benefits because the subsequent increase in cigarette prices would encourage hundreds of thousands of Americans, especially young people, to quit or not start smoking. The only way we can begin to significantly reduce the terrible human and economic toll taken on our society by cigarette smoking is to change the smoking habits of the next generation. Increasing cigarette prices is a simple and effective means to this end.

II. Support for Increased Cigarette Excise Taxes

A Los Angeles Times poll released in February, 1986, found that eight-one percent of the American public favors the idea of higher cigarette excise taxes. An increase in the Federal cigarette excise tax also has broad based support from virtually every major national organization concerned about our nation's health and our nation's youth. The Coalition on Smoking OR Health is joined by 44 other national public interest organizations in our support for an increase in the cigarette excise tax to 32 cents per pack. These forty-four organizations range from groups like the American Medical Association to the American Association of Retired Persons, from the American Public Health Association to the Childrens Defense Fund, the United Methodist Church, the YWCA, and the Junior League. A complete listing is attached to my testimony. These groups are primarily interested in this issue because of the impact higher cigarette prices can have among young people, as was shown in the Harvard University report cited earlier. The public health community, and the American public, are agreed that cigarette taxes should be increased. We urge the Committee to support our position by linking cigarette excise tax rates to consumer prices, and by eliminating the business tax deduction for cigarette excise tax payments.

III. The Costs of Cigarette Smoking

In a major report issued last fall, the Office of Technology Assessment estimated that smoking-related disease and lost productivity costs a total of $65 billion annually. Medicare and Medicaid costs alone total $3.8 billion each year.

The cost of smoking to our society is incurred by all Americans, two-thirds of whom do not smoke. The $22 billion annually in health care costs are not borne by smokers alone; every individual in America who pays for health insurance pays an extra $100 yearly in health insurance premiums because of smokers. The $3.8 billion annually spent by Medicare and Medicaid on smoking-related health care, is paid for by all of us, not just smoking American taxpayers. If the costs were to be covered by smokers alone, every pack of cigarettes sold would have to carry a $2.71 "user fee". In light of these figures, the modest increase in cigarette prices which would follow from terminating the cigarette industry's deduction of excise tax payments, and from tying cigarette excise taxes to consumer prices, is extraordinarily modest and is not even large enough to reimburse the Federal government for the economic costs of smoking.

The human costs of cigarette smoking are even greater: approximately 350,000 Americans die each year because of smoking-related disease. Eighty-three percent of all lung cancer cases, ninety percent of all chronic obstructive lung disease, and about one-third of all heart disease-related deaths, are caused by smoking. Yet, the cigarette industry spends more than $2 billion a year marketing its product to make this deadly addiction more attractive to new, young smokers. It should come as no surprise that eighty-five percent of current smokers started before or during their teenage years, and among high school students who smoke, 60% started by the time they turned thirteen. The Coalition on Smoking OR Health sees nothing unreasonable about requiring the cigarette industry to pay the full costs of being in the business of selling death and addiction.

Finally, the Federal government is losing more than $1 billion in annual revenues because of the existing business deduction for cigarette excise tax payments. In addition, because the excise tax has not kept pace with consumer price increases, the relative value of the cigarette excise tax has plummeted from 42% of the cost per pack in 1951 to 17% of the cost per pack in 1984. It is even lower today.

The industry's deduction of its excise tax payments results in the loss of $.04, or 25%, of the intended Federal revenues from the sixteen cent cigarette excise tax. In effect, the consumer, who does pay the full sixteen cent tax, is actually contributing an additional four cents to the industry's profits and only twelve cents to the Federal treasury. This revenue loss of $6 billion over five years, coupled with the diminishing value of the excise tax as prices increases but the tax does not, represents a significant revenue loss to the Federal government. Meanwhile, the $65 billion in yearly smoking-related health care and lost productivity costs continues to accrue. The Coalition believes that enactment of the proposed changes to cigarette excise tax policies is a prudent step for the Government to take on both health, and fiscal, policy grounds.

IV. Fairness

The discussion of cigarette excise taxes brings along with it concerns for those least able to bear additional financial burdens. For this reason the Coalition believes that any discussion about cigarette marketing, as well as excise taxes, must pay special attention to the circumstances of those populations at a disadvantage in our society. Unfortunately, the cigarette industry, in its marketing strategies, also pays those populations special attention.

The young, women, and minorities are the chosen targets of most cigarette advertising and promotion campaigns. They are targeted because the cigarette industry knows that it is the disadvantaged in any society which is most suceptible to images which claim social, financial, and sexual success for those individuals using a certain product. In this case, the product is cigarettes, and the marketing efforts aimed at seducing new, young smokers seems to know no limits. The industry spends more than $2 billion annually in its efforts to recruit the young through product promotion and advertising, and each campaign takes advantage of those role models, activities, and skills likely to be admired by young potential smokers.

The additional cost burden of the proposed excise tax provisons pales in the face of the cost burdens imposed by a lifetime of smoking. The average pack and a half per day smoker pays approximately $525.00 per year to support his cigarette habit; the cost increase resulting from the proposed excise tax changes would add 42 cents a week, or 6 cents per day, to this figure. Most important, however, are those health costs inevitably incurred by smokers which the poor are least able to afford; the health care costs, the lost worktime costs, and the cost of a premature death, not only to the smoker, but to his family as well.

For those individuals who choose to keep smoking, the additional costs which would follow from enactment of these two excise tax provisions are minor additions to the price they are already paying. But if these modest increases will deter the next generation from taking up smoking, it will save them from a lifetime of being chained to an addictive and debilitating habit.

V. Conclusion

The proposed elimination of the cigarette excise tax deduction, and the tying of cigarette excise tax rates to consumer prices, would increase Federal revenues while improving the public health. It is almost too good to be true - - but it is. Surgeon General C. Everett Koop has called for a "smoke-free society by the year 2000", and the Coalition on Smoking OR Health, and each of our member organizations, endorses this goal. To achieve it, we need to educate the new generation about the addictiveness of tobacco and its fatal health effects, to correct the misconceptions perpetuated by deceptive cigarette advertising and promotion, and, finally, to do what we can to end the social acceptability of a habit which kills more 350,000 Americans annually and debilitates hundreds of thousand more. Therefore, the Coalition on Smoking OR Health endorses the proposed excise tax changes for the cigarette industry and urges the Committee to adopt these provisions for cigarette excise taxes within, or without, a tax reform package. We endorse them simply as wise public health policy, important in the effort to reduce the single most preventable cause of death in America today.

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AD HOC GROUP FOR A 32 CENT FEDERAL CIGARETTE EXCISE TAX

1. AMERICAN HEART ASSOCIATION — one of the largest voluntary health agencies in the United States, and the only such agency that devotes all of its resources to the goal of reducing premature death and disability due to cardiovascular disease and stroke
2. AMERICAN LUNG ASSOCIATION — the nation's oldest voluntary health organization, committed to the prevention and control of lung disease
3. AMERICAN CANCER SOCIETY — the world's largest voluntary health agency, devoted to research, education, and service to the cancer patient, with over 2.3 million members
4. AMERICAN PUBLIC HEALTH ASSOCIATION — an association of over 50,000 community health leaders and health professionals working for the public health
5. AMERICAN ASSOCIATION OF RETIRED PERSONS — the largest organization representing older persons, with 18 million members; committed to advocacy and programs to meet the needs of the older population
6. ASSOCIATION OF STATE & TERRITORIAL HEALTH OFFICIALS — the professional organization representing the chief health officials of every state and territory in the U.S.
7. CHILDREN'S DEFENSE FUND — a national public charity that provides a strong and effective voice for children and adolescents, particularly those from poor and minority families, in public policy forums
8. NATIONAL BOARD, YOUNG WOMEN'S CHRISTIAN ASSOCIATION (YWCA) OF THE U.S.A. — an organization of 2.5 million members and participants working to promote equity, justice, peace, freedom and dignity for all people, but particularly for women and girls
9. NATIONAL COUNCIL ON THE AGING, INC. — a national organization representing providers of services to the elderly which serves as a principal advocate for issues of concern to our older population

10. NATIONAL ASSOCIATION OF ELEMENTARY SCHOOL PRINCIPALS — a professional organization serving more than 22,000 elementary and middle school principals in the United States and overseas, and believing that the progress and well-being of the child must be at the forefront of all elementary and middle school plans and operations

11. AMERICAN ASSOCIATION OF DENTAL SCHOOLS — an organization representing all sixty dental schools in the United States, their faculties and students, and their dental hygiene and hospital-based residency programs

12. AMERICAN DIABETES ASSOCIATION — a national voluntary health organization whose two-fold mission is to support the search for prevention and cure for diabetes and to improve the well-being of people who have diabetes and their families; consisting of 220,000 members, 8,600 professional members, 58 affiliates, and 700 chapters

13. AMERICAN MEDICAL STUDENT ASSOCIATION — an independent organization of more than 30,000 medical students committed to improvement of medical education and ensuring access to quality health care services

14. ADVENTIST HEALTH NETWORK — people who enjoy helping others, through education and direct assistance, in 800 centers connected with Adventist churches and schools across the country

15. AMERICAN ASSOCIATION OF PREFERRED PROVIDER ORGANIZATIONS — a professional association of competitive alternative health care delivery systems

16. ASSOCIATION OF AMERICAN CANCER INSTITUTES — all 59 privately and publicly funded cancer centers across the country, providing research, care and teaching

17. JOINT COUNCIL OF ALLERGY AND IMMUNOLOGY — is comprised of the American Academy of Allergy & Immunology, the American College of Allergists, and the American Association for Clinical Immunology and Allergy, and represents the speciality of immunology in the socio-economic and political spheres

18. ASTHMA & ALLERGY FOUNDATION OF AMERICA — a nationwide network of over 100 chapters and support groups and tens of thousands of concerned individuals banded together with a common mission of eradicate asthma and allergic diseases

19. AMERICAN GASTROENTEROLOGICAL ASSOCIATION — 4,000 physicians concerned with digestive diseases

20. CENTER FOR SCIENCE IN THE PUBLIC INTEREST — a consumer advocacy membership organization that seeks to improve national policies with regard to health and nutrition

21. ASSOCIATION OF SCHOOLS OF PUBLIC HEALTH — representing the 23 accredited graduate schools of public health in the United States

22. NATIONAL TAX EQUALITY ASSOCIATION — a business coalition examining current tax reform, with 1,500 business members

23. AMERICAN ASSOCIATION FOR RESPIRATORY THERAPY — a 27,000 member professional association for respiratory therapy practitioners across the country

24. AMERICAN ACADEMY OF OTOLARYNGOLOGY - HEAD & NECK SURGERY, INC. — a professional association concerned with ear, throat, nose, head and neck surgery, with approximately 7,500 members

25. AMERICAN COLLEGE OF OSTEOPATHIC PEDIATRICIANS — a professional organization of osteopathic physicians providing care to children

26. ASSOCIATION OF JUNIOR LEAGUES — an international women's volunteer organization with 244 member leagues in the U.S. representing approximately 149,000 individual members, promoting the solution of community problems through voluntary citizen involvement, and training members to be effective voluntary participants in their communities

27. NATIONAL PERINATAL ASSOCIATION — an interdisciplinary organization of professionals providing health care to infants and pregnant women

28. AMERICAN ACADEMY OF OTOLARYNGIC ALLERGY — an organization of physicians specializing in the treatment of the ears, nose, throat and related structures of the head and neck, with 1,200 members

29. AMERICAN SOCIETY OF CLINICAL ONCOLOGY — 4,500 clinical oncologists specializing in the treatment of cancer

30. AMERICAN NURSES ASSOCIATION — the largest professional association representing registered nurses in the country, with 185,000 members

31. AMERICAN SOCIETY OF INTERNAL MEDICINE — representing 20,000 physicians who specialize in internal medicine, and are concerned with the socioeconomics of medical care delivery

32. NATIONAL ASSOCIATION OF CHILDREN'S HOSPITALS AND RELATED INSTITUTIONS (NACHRI) — represents 90 children's hospitals in the United States and Canada. Its goal is to serve as an advocate for improved child health and the delivery of comprehensive quality health services for all children

33. AMERICAN COLLEGE OF CHEST PHYSICIANS — is a professional medical specialty society representing more than 11,000 physicians, scientists and educators specializing in pulmonary and cardiovascular diseases

34. AMERICAN COUNCIL ON SCIENCE AND HEALTH (ASCH) — is a national consumer education association directed and advised by a panel of scientists from a variety of disciplines. ASCH is committed to providing consumers with scientifically balanced evaluations of issues relating to food, chemicals, the environment and health

35. AMERICAN ACADEMY OF PEDIATRICS — an organization of 27,000 pediatricians dedicated to the health, safety and well-being of infants, children and adolescents in North, Central and South America

36. THE UNITED METHODIST CHURCH, DEPARTMENT OF HUMAN WELFARE — the United Methodist Church has 9.5 million members; the Department of Human Resources is responsible for the Church's positions on issues of public health and policy

37. AMERICAN LICENSED PRACTICAL NURSES' ASSOCIATION — a professional association of more than 3,000 licensed practical and vocational nurses who provide bedside nursing in settings including nursing homes, hospitals, clinics, and community health centers

38. AMERICAN COLLEGE OF CARDIOLOGY — a 14,000 member, non-profit professional medical society and teaching institution, dedicated to ensuring optimal care for persons with cardiovascular disease or those with the potential of developing cardiovascular disease, and through education and socioeconomic activities, to contributing significantly to prevention of cardiovascular disease

39. AMERICAN NEPHROLOGY NURSES' ASSOCIATION — an organization representing approximately 3,000 registered professional nurses and allied health professionals involved in all modalities of care and treatment, including hemodialysis, peritoneal dialysis, and transplantation, of patients with renal disease

40. NATIONAL ALLIANCE OF SENIOR CITIZENS, INC. — a national membership organization which focuses its attention on major issues facing older Americans; it is moderate to conservative in political philosophy, and has a membership of more than 3.5 million persons

41. TERRI GOTTHELF LUPUS RESEARCH INSTITUTE — founded as a national research center for the support and coordination of research and education on lupus and related immune system disorders

42. AMERICAN MEDICAL ASSOCIATION — a voluntary society of physicians founded to promote and improve the science and art of medicine and the betterment of public health. With approximately 250,000 members, the AMA's varied activities are directed toward achieving excellence among physicians and assuring the American public of the highest quality medical care possible

43. AMERICAN COLLEGE OF OBSTETRICIANS AND GYNECOLOGISTS — a non-profit organization representing over 26,000 obstetricians and gynecologists dedicated to the health of mothers and infants.

44. AMERICAN COLLEGE OF PHYSICIANS — the College represents over 60,000 doctors of internal medicine, subspecialists, and physicians-in-training; the membership includes private practitioners delivering primary health care; medical specialists in such fields as gastroenterology, endrocrinology and cardiology; medical educators; and researchers

Special Communication

Smoking and Health Implications of a Change in the Federal Cigarette Excise Tax

Kenneth E. Warner, PhD

• Cigarette excise tax changes ultimately influence the health of smokers and potential smokers. An 8-cent decrease in the federal tax is estimated to induce up to 1 million young persons, ages 12 to 25 years, to smoke, when without the tax decrease they would not. Hundreds of thousands of Americans older than 25 years would also start or continue smoking as a result of the tax decrease. Conversely, an 8- to 16-cent tax increase would encourage from 1 to 2 million young persons and 800,000 to 1.5 million adults to quit smoking or not to start. Thus, a tax increase could prevent hundreds of thousands of premature smoking-related deaths, while a tax decrease would contribute to the disease burden of tobacco. Intentionally or inadvertently, the federal cigarette excise tax is a powerful tool of public health policy.

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THROUGHOUT much of 1985, Congress and a variety of interest groups debated the desirability of a legislated halving of the federal cigarette excise tax. (The 1982 Tax Equalization and Fiscal Responsibility Act [TEFRA] included a doubling of the tax [from 8 to 16 cents per pack], effective Jan 1, 1983, as a temporary revenue-raising measure. The legislation included a sunset provision returning the tax to its pre-TEFRA level on Oct 1, 1985.) The debate focused on revenue and political implications. Of concern to health professionals, however, is the fact that a change in consumption resulting from a tax change will have health implications. A wealth of empirical research indicates that the number of cigarettes smoked varies inversely with changes in the price of cigarettes,[1] and tax variations constitute a major component of price differences. (Taxes vary across states at any one point in time and in the aggregate over time.) Recent econometric research has differentiated the price responsiveness, by age and sex, of smoking prevalence (ie, the decision whether or not to smoke) and daily consumption by smokers.[2,3] This article uses this evidence to estimate the numbers of teenagers and adults who would be induced to smoke by a federal tax decrease, or discouraged from smoking by a tax increase, and considers the health implications of these tax-related changes in smoking prevalence.

See also p 1049.

METHODS

Selection of Elasticity Estimates

The basis for estimating the consumption impacts of a change in the federal excise tax is an analysis of the price elasticity of demand for cigarettes. Elasticity is the basic measure of the degree of responsiveness of demand to changes in price, defined as the percentage change in the quantity of cigarettes demanded divided by the percentage change in price associated with the demand change. Thus, an elasticity of −0.7, for example, means that a 10% increase (decrease) in price would reduce (increase) the quantity of cigarettes demanded by 7%.

Numerous economists have undertaken empirical studies of the elasticity, with recent estimates ranging from −0.4 to −1.3.[1] In the present study, elasticity estimates developed by Lewit and his colleagues[2,3] are used to analyze the cigarette consumption and health impacts of a tax change. The work of these authors represents a substantial improvement in the analytical state of the art. Furthermore, Lewit and colleagues were the first analysts to study separately each of teenage and adult price responsiveness and to distinguish the influence of price change on the *fact* of smoking from its influence on the *rate* of smoking by continuing smokers.

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The salient estimates from the work of Lewit et al are presented in Table 1. The overall adult price elasticity of −0.42 falls at the lower end of the range of recent estimates (in absolute value). Use of this estimate, rather than a more average figure, reflects our opinion that the work of Lewit and Coate was better designed than that of earlier studies. In addition, use of a lower elasticity estimate ensures that estimates of tax-related consumption effects will be conservative.

The total price elasticity estimates (Table 1, column A) exhibit a pattern of price responsiveness decreasing with age, as would be expected for three reasons: (1) teenagers and young adults have smoking habits that are less well-defined and of shorter duration, implying less habituation or addiction and, hence, the potential for more price responsiveness; (2) younger people may be more inclined to start smoking as the result of a price decrease than would be older adults; (3) on average, younger people will have less disposable income, so that price response may include more of an income effect. Worthy of note is that teenagers' cigarette demand is quite elastic, while that of adults is relatively inelastic.

One of the most important findings in the estimates of Lewit et al is that "participation" or prevalence decisions (Table 1, column B) account for the vast majority of total price response. All of the daily quantity elasticity estimates (Table 1, column C) are small and derived from statistically nonsignificant regression coefficients, while all but two of the participation elasticities are derived from significant regression coefficients. It is possible that anomalies in smokers' reporting of their daily habits on the surveys could disguise a consumption change. For purposes of this article, however, the nonsignificance of the daily quantity elasticities will lead us to examine only participation and total consumption effects of price changes.

Table 1.—Cigarette Demand Price Elasticities*

	[illegible]		
Age Group, yr	A: Total	B: Participation†	C: Quantity per Day per Smoker‡
12-17	−1.40§	−1.20§	−0.25
20-25	−0.89§	−0.74§	−0.20
26-35	−0.47	−0.44	−0.04
36-74	−0.45§	−0.15	−0.14
All adults (20-74)	−0.42§	−0.26§	−0.10

*Calculated by Lewit and colleagues.[2,3]

†Prevalence elasticity. Reflects the decision of whether or not to smoke at all.

‡Implied from total and participation elasticities.

§Regression coefficients, from which elasticities derived, significant at $P < .05$.

Table 2.—Expected Percentage Changes in Cigarette Consumption Resulting From Changes in the Federal Cigarette Excise Tax

	8-Cent Decrease		8-Cent Increase		16-Cent Increase	
Age Group, yr	Total	Participation	Total	Participation	Total	Participation
12-17	11.9	10.2	−11.1	−9.5	−21.1	−18.1
20-25	7.6	6.3	−7.0	−5.8	−13.4	−11.2
26-35	4.0	3.7	−3.7	−3.5	−7.1	−6.6
36-74	3.8	1.3	−3.6	−1.2	−6.8	−2.3
All adults (20-74)	3.6	2.2	−3.3	−2.1	−6.3	−3.9

Estimation of Consumption Impacts

To estimate the consumption impacts of tax changes, we take the year 1984 as the base year and examine the effects of lowering the federal excise tax from 16 to 8 cents per pack or raising it to 24 to 32 cents. The halving of the tax represents the situation originally called for by TEFRA. A rate of 24 cents demonstrates the effect of a tax change of equal magnitude but opposite direction. Thirty-two cents, a rate proposed in several congressional bills in 1985, would simply restore the real value of the tax (ie, adjusting for inflation) to its value when the excise tax was first set at 8 cents in 1951.

In 1984, the weighted average retail price of a pack of cigarettes was 97.8 cents. If a decrease of 8 cents in the federal excise tax was associated with the retail price of cigarettes falling by the same amount, average price would fall by 8.5%. If, instead, the tax was increased from 16 to 24 or 32 cents, average price would rise by 7.9% or 15.1%, respectively. (The denominator is calculated at the mean of the pretax change and posttax change prices. We are assuming that all other things remain equal. Changes in cigarette production and distribution costs and in state and local excise taxes will also affect cigarette price. Here we are concerned exclusively with the effects of a federal tax change.) Applying the elasticity figures from columns A and B of Table 1 implies that the expected percentage changes in consumption would be those presented in Table 2.

Table 3 presents estimates of the numbers of smokers in each age category studied by Lewit and his colleagues, as well as older teenagers (18 to 19 years) and older senior citizens (75 years or older). Also included in Table 3 are estimates of average daily consumption in each group and the group's total annual consumption. To estimate quantitative changes in numbers of smokers and each age group's annual consumption, we simply multiply the relevant base figures in Table 3 by the percentage changes in Table 2.

RESULTS

Estimates of the consumption impacts of the three tax changes are presented in Table 4. Estimates for 18- to 19-year-olds and the most elderly adults (75 years or older) are calculated as described in the footnote to Table 4.

An 8-cent decrease in the excise tax would induce almost 2 million persons to smoke who would not do so if the tax was to remain at 16 cents. This number includes both persons initiating or resuming smoking habits and continuing smokers who would have quit without the economic prod to continue. Among the 1.9 million are more than 460,000 teenagers who would begin or continue smoking as a result of the tax decrease. Adding in the most price-responsive adults, those aged 20 to 25 years, we find that more than 1 million young people would join the ranks of the smoking population in the event of an 8-cent tax decrease.

An 8-cent tax *increase* would have a quantitatively similar opposite effect: 1.8 million persons would be encouraged to quit or not begin smoking, including more than 400,000 teenagers and more than half a million young adults aged 20 to 25 years (and more than a million young adults aged 20 to 35 years). A 16-cent increase in the excise tax would encourage almost 3.5 million Americans to forego smoking habits in which they would engage if the tax were to remain at 16 cents per pack. This figure includes more than

800,000 teenagers and almost 2 million young adults aged 20 to 35 years.

The aggregate annual changes in cigarette consumption are substantial in absolute magnitude, ranging from an increase of more than 20 billion cigarettes to a decrease of more than 36 billion, but represent a relatively small proportion of the domestic cigarette market (from 3.4% to 6.1%).

COMMENT

Assumptions Underlying Analysis

The analysis is predicated on several assumptions that could introduce bias into the estimates of consumption impacts. One of the assumptions is that price will change by the full and exact amount of the tax change, the assumption employed in virtually all cigarette demand elasticity studies that supply is perfectly elastic. The one study to address this issue suggests that retail prices have risen by slightly more than taxes.[7] Some observers conjecture, however, that pricing responses to tax increases and decreases may differ, with tax decreases not producing commensurate decreases in price.[1] This conjecture suggests collusive behavior, a possibility in a six-firm oligopoly in which two firms control two thirds of the entire domestic market. If this model is valid, it suggests that an 8-cent decrease in the federal tax would not produce an 8-cent decrease in retail price, mitigating increases in cigarette consumption by an amount proportionate to the fraction of the tax decrease not passed on to consumers. To the extent that this occurs, the effect of a tax decrease would be to shift revenue from the federal treasury to the cigarette companies.

A second major assumption is that consumption responses to price increases and decreases are symmetrical, ie, that an elasticity implies the same percentage change in consumption for both a price increase and a price decrease of a given percentage. There is reason to suspect, however, that consumption responses may be asymmetrical, particularly for adults. Very few people begin to smoke after the age of 21 years. Hence, cigarette price decreases might be unlikely to induce adults to start to smoke, while price increases could encourage some smokers to quit. The implication is that price response might be considerably greater in the instance of price increases than decreases. If this were true, our estimates in Table 4 would overstate the consumption impact of an 8-cent tax decrease and understate the impact of an 8- or 16-cent tax increase. Note, however, that an argument can be made in support of symmetry: the adult smoking prevalence elasticity is relatively small and may reflect roughly comparable amounts of quitting smoking in response to price increases and recidivism by previous quitters in response to price decreases.

A third assumption derives from the fact that this analysis does not consider differential responses to tax changes by sex. Evidence on sex differences in price response suggests that smoking by men would be affected much more substantially than smoking by women. It is plausible, however, that sex-specific price elasticities based on recent data would exhibit less of a differential than those derived from data now ten years old.[1] If women's price responsiveness were approaching the greater price responsiveness of men, the overall elasticity would be greater in absolute value than the −0.42 used in this study, and the numbers of smokers affected by a tax change would increase correspondingly.

Lack of substantial empirical evidence pertaining to these issues makes it impossible to determine whether our estimates in Table 4 should be adjusted, and even in what direction. It is important to empha-

Table 3.—Estimated Numbers of Smokers, Average Daily and Annual Consumption by Age, 1982

Age Group, yr*	A: No. (%) of Smokers*	B: Average Daily Consumption of Smokers, No. of Cigarettes†	C: Total Annual Consumption of Group, Billions of Cigarettes‡
12-17	3,279,000 (14.7)	16.0	19.1
18-19	1,877,000 ([illegible])	17.8	[illegible]
20-25	9,666,000 (36.3)	18.0	63.5
26-35	13,722,000 ([illegible])	[illegible]	[illegible]
36-74	26,963,000 (31.8)	21.8	214.5
75+	1,814,000 ([illegible])	17.3	8.4
Total	56,230,000 (29.3)	20.2	415.3

*Age group population figures were taken from 1982 estimates by the Bureau of the Census. Smoking participation data, provided by the Office on Smoking and Health, Department of Health and Human Services, were from a 1982 National Institute on Drug Abuse (NIDA) household survey (12- to 17-year-olds) in which smoking was defined as daily use of cigarettes during the preceding 30 days; the 1984 NIDA survey of high school seniors' drug use (cigarette use rate, defined as above, applied to 18- to 19-year-olds); and the 1983 Health Interview Survey (HIS) (adults), in which current smokers were defined as those currently smoking cigarettes and having a lifetime consumption of 100 or more cigarettes. Use of the NIDA data may produce a small underestimate of smoking by 18- to 19-year-olds, as high school seniors are one year younger and may have lower rates of cigarette smoking than high school dropouts. Age groupings of the HIS data and the studies by Lewit and Coate[3] and Lewit et al[2] differ slightly. The HIS rate for 20- to 24-year-olds was used for 20- to 25-year-olds here. Similarly, the HIS rate for 25- to 34-year-olds was used for 26- to 35-year-olds. HIS broke down rates for those over 35 years into the following categories: 35 to 44 years, 45 to 64 years, and 65 years or more. In the present Table 3, a rate somewhat higher than the 65+ rate was used for 65- to 74-year-olds and a lower rate for those 75+ years, the two yielding the HIS rate for the entire group aged 65+ years. Each of these adjustments introduces potential errors of such small magnitude as to be inconsequential for the largely qualitative purposes of the article.

†Average daily consumption figures for teenagers were estimated from data in exhibits A-1 and 16 in a report on teenage smoking by the National Institute of Education[8] and data supplied by the National Center for Health Statistics (NCHS) from the 1983 NIDA study of high school seniors' drug use. For adults, the figures were estimated from the census and the 1983 HIS, supplemented by data provided by NCHS from a 1980 telephone poll of the HIS. The latter yielded detailed averages of daily consumption, while the 1983 HIS data were available only in categories (fewer than 15, 15 to 24, or 25+ cigarettes). As with the estimation of numbers of smokers in column A, estimation of average daily consumption in age groupings corresponding to those used by Lewit and colleagues required a number of assumptions and interpolations. In particular, the teenage daily use estimates might better be considered educated "guesstimates," and the figures for 12- to 17-year-olds seem high to the author and knowledgeable colleagues. All of these figures, however, are quite consistent with earlier estimates of daily consumption as reported on surveys, and deviations of data for teenagers from reality are of no importance to this analysis. It is important to keep in mind, as noted in the succeeding footnote, that self-reports of daily consumption fall well below objective measures of consumption. As is discussed in the text, the statistical nonsignificance of the daily consumption elasticities makes examination of tax effects on the daily use variable largely a qualitative exercise anyway.

‡Equals A × B × 365. The total estimated annual consumption is only slightly over two thirds of the nearly 600 billion cigarettes US smokers actually consume each year. This is consistent with the observation that Americans tend to underreport their levels of cigarette consumption.[9]

Table 4.—Estimated Changes in Cigarette Smoking Attributable to Changes in the Federal Cigarette Excise Tax*

Age Group, yr	8-Cent Decrease	8-Cent Increase	16-Cent Increase
Change in No. of Smokers (Thousands)			
12-17	+334	−312	−596
18-19	+130	−121	−231
20-25	+609	−570	−1,080
26-35	+509	−480	−906
36-74	+351	−324	−620
75+	+13	−12	−23
Total	+1,946	−1,819	−3,456
Change in Aggregate Cigarette Consumption (Billions of Cigarettes)			
12-17	+2.3	−2.1	−4.0
18-19	+1.0	−0.9	−1.7
20-25	+4.8	−4.4	−8.6
26-35	+4.1	−3.8	−7.2
36-74	+8.2	−7.7	−14.6
75+	+0.2	−0.2	−0.4
Total†	+20.6	−19.1	−36.4

*The percentage changes for 36- to 74-year-olds have been applied to the oldest group of adults (75+ years) as well. Smokers in this age bracket may be more confirmed smokers than younger adults, perhaps implying less price response, but they are also likely to be poorer on average, implying more response to a price change. Note that these smokers constitute less than 2% of the smoking population. For 18- to 19-year-olds, percentage changes midway between those of 12- to 17-year-olds and 20- to 25-year-olds have been used.

†The absolute value of each of these totals is about 6% greater than the figures calculated by combining the prevalence and daily consumption changes directly. This results from the estimation procedure for the different elasticities used by Lewit and Colleagues.[2,3]

size, however, that except in the case of *no* drop in retail price following a tax decrease, which is extremely unlikely, the qualitative results of the analysis would hold: an 8-cent tax decrease would encourage tens or hundreds of thousands of Americans to smoke who would not otherwise do so; a tax increase of the magnitude considered would encourage many hundreds of thousands, and likely millions, of Americans to quit smoking and, in the case of youngsters, not to start.

All such tax-induced consumption changes would be maintained only if the real value of the tax change was preserved, for example through ad valorem taxation. If inflation eroded the value of the tax change, the consumption impacts would diminish over time.

Health Implications

The ultimate importance of tax-induced changes in cigarette consumption lies in their health consequences. The fact that one lifelong smoker of every three or four dies of a smoking-related illness can be used to produce some upper-bound estimates of the mortality implications of the contemplated tax changes. For example, if we assume that one of every four tax-induced quitters (or nonstarters) would have died from smoking, the estimates in Table 4 imply that the 8-cent increase would avert the smoking-induced premature deaths of 450,000 Americans. The 16-cent increase would prevent 860,000 premature deaths. By contrast, if the 8-cent decrease took effect, more than 480,000 Americans would die prematurely as a result of their tax-induced initiation or continuation of smoking habits.

As with the consumption estimates, these numbers are sensitive to several assumptions, including those relating to pricing, symmetry of price response, and preservation of the real value of the tax change. Also important is recognition that medical practice and technology may improve in the future to the point that many now-fatal heart and lung diseases and cancers will become curable. To the extent that this occurs, the potential mortality savings of a tax increase or the deaths resulting from a tax decrease will be diminished. Morbidity implications are less obvious, as avoidance of death as a medical outcome could translate into increases in experienced illness and disability. A subtle smoking response to price changes, not discussed to this point, could also affect morbidity and mortality. While price increases might lead to fewer cigarettes being smoked, smokers might inhale these cigarettes more deeply, smoke them further down, and take more puffs. Some smokers might switch to cigarettes rated higher in tar and nicotine delivery. Each of these behaviors presumably would offset partially the health benefit derived from a reduction in the aggregate level of smoking. Similarly, price decreases could lead to less intensive smoking or the resultant greater numbers of cigarettes consumed, also mitigating the health consequences of increased consumption.

The premature deaths averted or produced by a tax change are not realized all at once. The major consumption changes induced by a cigarette price change will occur in the youngest groups of smokers and potential smokers—teenagers and young adults. Thus, the majority of the premature deaths that would be associated with a tax decrease, or of the premature deaths avoided as the result of a tax increase, would occur three to five decades into the future. The most immediate mortality implications relate to tax-induced changes in smoking prevalence in middle-aged and older adults. Given the large numbers of smokers in these age categories, this still translates into a substantial mortality implication for the near future; but it is only a fraction of the totals given above. For example, according to Table 4, close to a third of a million Americans aged 36 years and older would quit smoking if the federal excise tax were raised by 8 cents; more than 640,000 would quit if the tax were doubled to 32 cents per pack. Given the earlier assumptions, these figures would translate, respectively, into 84,000 and 161,000 premature deaths that would be averted in the more immediate future, from the year of the tax increase extending into the following three decades.

With regard to socioeconomic status (SES), a factor we have not discussed to this point, it is highly likely that the lower SES groups are more price-responsive than their more affluent counterparts.[7] As such, one must assume that a tax increase would cause relatively more poor smokers to forego smoking, while a tax decrease would encourage relatively more members of the lower SES classes to start or continue smoking. The latter would exacerbate the situation that smoking and its associated disease effects increasingly are becoming more class-based (*Wall Street Journal*, June 25, 1985, pp 1 and 25). A tax increase, by contrast, would mitigate this tendency.

Conclusion

The overall relative consumption impact of plausible tax changes is modest, only on the order of a few percentage points, but the size of the cigarette-smoking population means that even modest relative changes become substantial effects in terms of absolute magnitude. This is readily illustrated by the fact that, if the basic assumptions hold, an 8-cent tax change would alter the size of the smoking population by less than 3.5%, but that 3.5% represents almost 2 million Americans. This number, in turn, translates into substantial implications for avoidable morbidity and premature mortality.

The health implications of tax-induced consumption changes are of most immediate importance in the population of middle-aged and older adults, because these are the individuals most prone to experience smoking-related illness. The elasticity estimates produced by Lewit and colleagues show this group to be the least price-responsive, yet the sheer size of this group means that, under the assumptions used for the tables, from 330,000 to 640,000 would alter their smoking status if the federal tax were changed.

In the long run, the toll of smoking is tied to the smoking practices of the youngest generation. There is a widespread consensus that the ultimate conquest of smoking-induced illness can come only from preventing the onset of smoking in the teenage and early adult years. In this regard, the findings of this study are particularly important. Not only do the price responses represent large numbers of young persons, they also represent substantial proportions. An 8-cent decrease in the federal excise tax would increase the ranks of teenage smokers by a tenth, assuming the decrease was fully passed on to consumers. A 16-cent tax increase would diminish the population of teenage smokers by fully 17%. The former would lead approximately 460,000 teenagers in the direction of cigarette habits; the latter would lead 820,000 teenagers away from dependency on cigarettes.

Intentionally or inadvertently, a change in the federal cigarette excise tax is a potent tool of health policy.

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STATEMENT OF GERRY OSTER, PH.D., VICE PRESIDENT, POLICY ANALYSIS, INC., BROOKLINE, MA

Mr. OSTER. Thank you, Senator.

My name is Gerry Oster, and I am a vice president of Policy Analysis, Inc., a medical and health economics consulting firm located in Brookline, MA. I am also the author of a book on the costs to the United States of smoking-related disease.

I am here today to testify in support of the proposed excise tax provisions in the tax bill pending before the committee as they apply to cigarette excise taxes.

The proposals would: One, eliminate the business tax deduction for cigarette excise tax payments, and two, tie cigarette excise tax rates to consumer prices. I support these proposals because they will generate needed revenues for the Federal Treasury while encouraging thousands of teenagers not yet addicted to tobacco not to start smoking.

In revenue terms, the first proposal alone will generate approximately $6 billion over 5 years. In human terms, these proposals will save much more.

My testimony will focus on three major issues—cigarette prices and their impact on cigarette consumption, the fact that cigarette excise taxes as a source of Federal revenue have actually declined over the past 30 years, and the fairness of the cigarette excise tax as tax policy.

With respect to my first point, how cigarette prices affect consumption, in a report recently published in the Journal of the American Medical Association it was estimated that a 10-percent increase in the price of cigarettes would result in a 7-percent drop in total cigarette consumption. The effect of cigarette prices on consumption among young people is especially pronounced. The young, particularly teenagers, are strongly influenced in their decision to smoke or not by even small changes in prices.

The health implications of reduced cigarette consumption are far-reaching. In the long run, the toll of smoking is tied to the smoking practices of our youth. A modest increase in the price of cigarettes which would deter hundreds of thousands of young people from taking up or continuing the cigarette habit will avert thousands of premature deaths and as yet uncalculated costs from smoking-related disease and disability.

It is clear that the $65 billion currently lost every year because of smoking-related health care costs and work loss could be substantially reduced if the next generation of potential smokers were deterred from a lifetime addiction to cigarettes.

The proposed revision to the cigarette excise tax would have this effect, because it would increase cigarette prices by approximately 4 cents. The current deductibility of cigarette excise tax payments by the tobacco industry enables it to retain about 4 cents out of the 16-cent Federal excise tax, based on an estimate by the Joint Committee on Taxation. This is possible, even though the industry pays the full 16 cents per pack at the point of manufacture because, by deducting the 16 cents per pack as a business expense, the manufacturer's total tax liability is reduced.

The elimination of the deductibility of the cigarette excise tax would result in higher cigarette prices, because historically the industry has passed on to the consumer similar federally mandated increases in its operating costs.

With respect to my second point, the historical role of cigarette excise taxes, we should note that the absence of a mechanism by which cigarette excise taxes are adjusted to keep pace with consumer price increases has led to a significant devaluation of the Federal cigarette excise tax as a revenue tool.

In 1951, when an 8-cent cigarette excise tax was instituted, the excise tax represented 42 percent of the cost of a pack of cigarettes, which then averaged 19 cents. Since 1951 the Consumer Price Index has nearly quadrupled; but the recent permanent extension of the 16-cent excise tax merely brings the tax up to 17 percent of the current per pack cost.

As a percentage of total Federal revenues, cigarette excise taxes have declined from about 2½ percent of total revenues in 1951, when the tax was 8 cents, to less than 1 percent of total Federal revenues in 1984, even with the 16-cent cigarette excise tax.

Thus, the actual Federal tax burden on cigarettes has declined significantly since 1951, even though in absolute terms the revenues from cigarette excise taxes have increased.

Clearly, tying cigarette excise tax rates to consumer prices is essential for maintaining the relative value of the cigarette excise tax as a source of revenue to the Federal Government.

Finally, the issue of fairness. One concern frequently expressed during discussion of cigarette excise taxes is that of fairness, because of the impact of a tax increase on lower income Americans. While I share this committee's concern for the welfare of the poor, there are several important considerations.

First of all, at the 1984 average cigarette price of 96 cents per pack, pack and a half per day smoker spends approximately $525 per year on cigarettes. The additional cost of 4 cents per pack—namely, that which would result from the elimination of the deductibility of the industry's excise tax payment—would add 6 cents per day or about $2 per month to this annual cost of $525. This is not an unduly burdensome tax increase.

In addition, work by researchers at MIT has indicated that low-income Americans actually smoke less than middle-income Americans, and that the actual dollar burden of a cigarette price increase is greater for whites than for blacks in every income category.

These findings on income and smoking have been corroborated by the 1979 Surgeon General's Report on Smoking and Health. That report documented that smoking rates among males are highest among middle-income levels, while smoking rates for women rise steadily with income.

The cigarette tax, in summary, falls most heavily on people who can afford to pay it.

To summarize——

The **CHAIRMAN**. Thirty seconds.

Mr. **OSTER**. Thank you.

The elimination of the cigarette industry's deduction for excise tax payments and the tying of the cigarette excise tax to consumer prices would have substantial monetary benefit to the Federal Government. The elimination of the deductibility and the tying of the cigarette excise taxes to consumer prices is wise tax policy, both in terms of its fiscal implications as well as its health consequences for the American public.

Thank you, Senator.

The CHAIRMAN. Thank you, Doctor.

[Mr. Oster's written prepared testimony follows:]

TESTIMONY OF

GERRY OSTER, PhD.

Vice President of

POLICY ANALYSIS, INC.

BROOKLINE, MASSACHUSETTS

Before The

SENATE COMMITTEE ON FINANCE

On

Hearings On The Excise Tax Provisions

In The Proposed Tax Reform Legislation

Monday
April 21, 1986

Introduction

My name is Gerry Oster, and I am a Vice President of Policy Analysis, Inc., a medical and health economics consulting firm in Brookline, Massachusetts. I am here today to testify in support of the proposed excise tax provisions in the tax bill pending before the Committee as they apply to cigarette excise taxes. The proposals are to 1) to eliminate the business tax deduction for cigarette excise tax payments and 2) tie cigarette excise tax rates to consumer prices. I support these proposals because they will generate needed revenues for the Federal treasury, while encouraging thousands of teenagers not yet addicted to tobacco not to start smoking. In revenue terms, the first proposal alone will generate approximately 6 billion dollars over 5 years, based on an estimate made by the Joint Committee on Taxation. In human terms, these proposals will save much more. My testimony will focus on three major issues: cigarette prices and their impact on cigarette consumption, the fact that cigarette excise taxes as a source of Federal revenue have actually declined over the past 30 years, and the fairness of cigarette excise taxes as tax policy.

I. How Cigarette Prices Affect Consumption

Dr. Kenneth Warner, in a report published last spring by the Harvard University Institute for the Study of Smoking and Behavior and Policy, and updated in an article published in the February 28, 1986 Journal of the American Medical Association (JAMA), a copy of which is included with my written statement, estimates that a 10% increase in the price of cigarettes would result in a 7% drop in total cigarette consumption. The effect of cigarette prices on consumption among young people is especially pronounced. The young, particularly teenagers, are strongly influenced in their decision to smoke or not by even small changes in prices.

The health implications of reduced cigarette consumption are far reaching. In the long run, the toll of smoking is tied to the smoking practices of the youngest generation. Since young people are the most sensitive to changes in price, the impact of increased cigarette prices hold long term health and economic benefits for the future. One out of four life-long smokers dies of a smoking-related illness; currently, more than 350,000 Americans dies annually because of cigarette smoking. A modest increase in the price of cigarettes, which would deter hundreds of thousands of young peple from taking up or continuing the cigarette habit, will avert hundreds of thousands of premature deaths, and as yet uncalculated costs from smoking-related disease and disability. It is clear that the $65 billion currently lost annually because of smoking-related health care costs and lost productivity would be substantially reduced if the next generation of potential smokers were deterred from a lifetime addiction to cigarettes.

The proposed revisions to cigarette excise taxes would have the effect of increasing cigarette prices by approximately four cents. The current deductibility of cigarette excise tax payments by the industry enables it to retain for itself four cents out of the sixteen cent federal excise tax. This is possible even though the industry pays the full sixteen cents per pack at the point of manufacture because, by deducting the sixteen cents per pack as a business expense, the manufacturer's total tax is reduced. This method of paying excise taxes contrasts sharply with that of the airline industry, which adds the passenger ticket tax at the point of sale, and sends it on to the Federal government without ever actually counting the tax as either a payment or as income. Thus, even though the industry actually pays to the Federal government only twelve cents of the sixteen cent tax, the consumer is charged, and the industry counts as a deduction, the full sixteen cent tax.

The elimination of the deductibility of cigarette excise tax payments would result in higher cigarette prices because historically the industry has passed on to the consumer similar Federally-mandated increases in its operating costs. In 1982, when the Tax Equity and Fiscal Responsibility Act (TEFRA) mandated a temporary increase in the eight cent cigarette excise tax to sixteen cents, the industry passed on this increase, and more, to the consumer.

II. The Historial Role of Cigarette Excise Taxes

The absence of a mechanism by which to adjust cigarette excise tax rates to keep pace with consumer price increases has led to a significant devaluation of the Federal cigarette excise tax as a revenue tool. In 1951, when an 8 cent cigarette excise tax was instituted, the excise tax represented 42% of the cost of a pack of cigarettes, which then averaged 19 cents. Since 1951, the consumer price index has nearly quadrupled, but based on a 1984 average price per pack of 96 cents, the recent permanent extention of the 16 cent excise tax merely brings the tax up to 17% of the per pack cost. As a percentage of total Federal revenues, cigarette excise taxes have declined from 2.51% of total revenues in 1951, when the tax was 8 cents, to .71% of total Federal revenues in 1984, even with the sixteen cent cigarette excise tax. As a percentage of GNP, cigarette excise tax revenues have declined from .47% in 1951 to .13% in 1984, a 72% decline. Thus, the actual Federal tax burden on cigarettes has declined significantly since 1951, even though in absolute dollars the revenues from cigarette excise taxes have increased. Clearly, tying cigarette excise tax rates to consumer prices is essential for maintaining the relative value of the cigarette excise tax as a source of revenue to the Federal government.

III. Fairness.

One concern frequently expressed during discussion of cigarette excise taxes is that of fairness because of the impact of a tax increase on lower income Americans. While we share this Committee's concern for the welfare of the poor, the generalization obscures several important considerations. At the 1984 average cigarette price of 96 cents per pack, a pack and a half per day smoker spends approximately $525.00 per year on cigarettes. The additional cost of 4 cents per pack which would result from the elimination of the deductibility of the industry's excise tax payment, would add just six cents per day or 42 cents a week, to this annual cost of $525.00. This is not an unduly burdensome tax increase.

In addition, research by Professor Jeffrey E. Harris of the Massachusetts Institute of Technology indicates that low income Americans smoke less than middle income Americans. Noting that older Americans, who make up a sizeable fraction of low income Americans, have much lower smoking rates than the general population, Professor Harris found that in considering the number of cigarettes smoked per day, the actual dollar burden of a cigarette price increase is greater for whites than for blacks in every income category.

Professor Harris' findings on income and smoking have been corroborated by the 1979 Surgeon General's Report on Smoking and Health. That report documented that smoking rates among males are highest among middle-income levels, while smoking rates for women rise steadily with income. The poorer the woman, the less likely she is to smoke. The cigarette tax, in summary, falls most heavily on people who are well able to afford it.

Finally, the increased Federal revenues which would follow from these changes could be made available to support necessary programs during a period of scarce fiscal resources, and could assist this Committee in fashioning a more equitable tax structure.

IV. Conclusion

The termination of the cigarette industry's deduction for excise tax payments and the tying of cigarette excise tax rates to consumer prices, would have substantial monetary benefit to the Federal government. In the short term, these benefits are the increased Federal revenues of over $1 billion annually. In the long term, cost-savings would be realized through the decreased incidence of smoking-related diseases and disability, which would follow from decreased cigarette consumption by the next generation.

Currently, the Federal government is collecting only 12 cents, or 75%, of the 16 cent Federal cigarette excise tax, and the value of that sum is constantly being eroded by consumer price increases which are not reflected in cigarette excise tax rates. The loss of this four cents alone accounts for $6 billion in lost revenue over 5 years; the lack of a price-related excise tax has meant a 150% decrease in the relative value of the cigarette excise tax, causing it to fall from 2.51% to less than 1% of total Federal revenues. Without enactment of consumer price-related excise tax increases, future revenue losses can only be conjectured, but it is improbable that past patterns of inflationary increases will change significantly. The elimination of the deductibility of cigarette excise tax payments, and the tying of cigarette excise taxes to consumer prices, is wise tax policy for both its fiscal, and its health, consequences.

BIOGRAPHY

Gerry Oster, PhD., is a Vice President of Policy Analysis, Inc., a medical and health economics consulting firm in Brookline, Massachusetts. Prior to his joining Policy Analysis, Inc., he was an Assistant Professor of Economics at the City University of New York. Dr. Oster received his B.A. in economics from the University of California at Santa Cruz, and his PhD., from the State University of New York at Stony Brook. He is the author of Economic Costs of Smoking and the Benefits of Quitting, as well as of several articles on the economics of smoking. Dr. Oster acts as a consultant to government and private agencies on the subject of the economics of smoking.

The CHAIRMAN. Mr. Wilson, if we eliminate deductibility, or, in the alternative, if we simply increase the cigarette tax, would the tobacco industry by and large pass the cost through to the consumer?

Mr. WILSON. Yes, sir.

The CHAIRMAN. You would not, as the oil companies have had to do with the windfall profits tax, be able to eat it because of international competition? You could pass it through?

Mr. WILSON. You are talking about the nondeductibility provision, Senator?

The CHAIRMAN. Well, either the nondeductibility or, in the alternative, let us say that we just added, as we almost did in this committee, another 16 cents to the cigarette tax.

Mr. WILSON. Well, that would automatically be added to the price, exfactory. Yes, sir.

The CHAIRMAN. And the nondeductibility you would pass through, also?

Mr. WILSON. We would pass that through, also.

Senator, could I make a point relative to numbers? We have had a lot of numbers thrown around this morning. We have heard 4 cents, and we have heard 9 cents, and we have heard a lot of numbers.

Let me say that the price increase at the manufacturer level is only one element of the passthrough. I believe Senator Chafee made that point. You would see that, going through the distribution channels, marked up. And we would estimate that the final average increase per pack would be somewhere between 17 percent, which is Mr. Blalock's figure, or as much as 25 percent. Pick 20 percent as probably a good ballpark.

The CHAIRMAN. A further question: You indicated on pages 6 and 7 of your testimony that if we need additional revenues it should be done with some kind of a "broad based mechanism." What are you thinking of?

Mr. WILSON. Well, sir, in general terms, the committee might want to wish to consider to go back and look at the rate structure, the corporate rate structure.

The CHAIRMAN. Do you mean raise the corporate rate structure?

Mr. WILSON. It is something the committee might wish to look at again. Yes, sir.

The CHAIRMAN. Well, if we are willing to stick to the 46-percent corporate rate structure, there are all kinds of things we can do. Would that be acceptable to you, to produce the revenues we need?

Mr. WILSON. As you know, Senator, I have been a big advocate of tax reform. I have met with you on the subject before. And one of the objectives of the CEO tax group that was founded a couple of years ago was broad based, revenue-neutral tax reform and a lower corporate rate. Of course, we did not deal with the personal side of the consideration; we didn't think that was our responsibility. But we would like to see lower rates, unquestionably.

The CHAIRMAN. I understand that. But you are saying if we have to have a base-broadening mechanism, keep the corporate rate where it is, or not lower it, certainly, as much as is in the House bill?

Mr. WILSON. Well, I wouldn't want to see it maintained where it is; but, perhaps something in excess of 35 percent ought; to be considered.

The CHAIRMAN. Well, as I recall, that will raise about $9 billion. At about $12 billion a point, we are $100 billion short, roughly—$90 to $110 billion. We would have to go up about 8 or 9 percent.

Mr. WILSON. I understand the challenges that are facing you and your committee, Senator.

The CHAIRMAN. Well, I am glad to have your approval of going up on the corporate rate. That will make the job easier, if we don't get the excise taxes.

Mr. WILSON. Well, I think we would have to see what the rate is before we said specifically we thought it was a good idea. But I am just suggesting that maybe this is something the committee might want to look at as an alternative here.

The CHAIRMAN. Well, with your support we will. [Laughter.]

Mr. WILSON. Many of my colleagues won't agree with that, by the way, Senator.

The CHAIRMAN. Next, what about the arguments that both Dr. Oster and Mr. Myers make about the taxation of cigarettes relative to where they were taxed in 1951 and, if we had at all kept the proportion, the tax would have been infinitely higher?

Mr. WILSON. Well, of course first of all, Senator, I don't think it appropriate for me to engage in a discussion or a dialog on the smoking and health controversy.

The CHAIRMAN. No, this is not health. I do not mean for this to be a debate on health.

Mr. WILSON. If we go back to 1951, the argument has been raised that the excise tax on cigarettes, at least, has not kept pace with the Consumer Price Index.

I think what people too often forget is that when you talk about the excise tax burden on the American consumer, you are talking at it at three levels: We have Federal, we have State, and we have local. Now, if you added all of that up since 1951 and applied it to the Consumer Price Index, my statistics demonstrate that the excise tax that the American consumer pays for a pack of cigarettes has kept pace with the CPI.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. No questions, Mr. Chairman.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. No questions, Mr. Chairman.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Well, Mr. Chairman, I would just like to ask Mr. Wilson, following up on your line of questioning.

It is correct, is it not, Mr. Wilson, that it is not solely a narrow question of either increasing excise taxes or having a lesser reduction in corporate tax rates? Both the President's proposal and the House managed to accomplish the objective without increasing excise taxes by what some have described as closing loopholes or making other changes. Would you not agree that that is an alternative that is before this committee, as well as those that have been posed in the previous questioning?

Mr. WILSON. Yes, sir. I certainly agree. If my memory serves me correctly, Treasury I and II didn't have any fundamental tax increases; what it did was to reform the Tax Code, which I personally believe is badly needed.

Senator **Mitchell**. Thank you.

I have no more questions, Mr. Chairman.

The **Chairman**. Senator Long.

Senator **Long**. Mr. Myers and Dr. Oster, if everybody reacted to the problem the way I have, I don't think we would be talking about it today, because after those revelations came out I quit smoking. So did my children. There are no smokers in my family; we all quit—all the inlaws, the outlaws, the whole bunch of my clan all quit. [Laughter.]

So, there wouldn't be any revenue to talk about if everybody reacted to those disclosures the way I did.

I happen to have been a very good friend of the late Dr. Alton Oschner. In respect to him—he is dead now—he is the one who insisted on proving up a causal connection between cigarettes and lung cancer. He pointed out to me many times that lung cancer is just a small part of it, that if you look at what it is doing by way of heart and what it is doing by way of stroke, and these other diseases, lung cancer is just a part of that. Is that right, Doctor?

Mr. **Oster**. I would agree wholeheartedly, Senator. I think the issue here is what is the message that we want to send out. I was quite heartened to hear the Secretary talk in terms of external costs, because I think that is the relevant argument and an essential issue to address with respect to the cigarette excise tax.

There is no question about the fact that cigarette smoking imposes additional external costs on the American public, both smokers and nonsmokers, and I think it is a quite persuasive argument to look at the excise tax on cigarettes as a way of having smokers partially reimburse the rest of society for the additional costs that they impose upon society.

Senator **Long**. No further questions, Mr. Chairman.

The **Chairman**. Let me ask Mr. Blalock or Mr. Wilson a question: The Joint Tax Committee, on all of the excise taxes, presumes that we collect about 78 percent of them because of the deduction. While most voters may think there is a Federal 16 cents per pack, we don't collect 16 cents. Do you agree with that assessment?

Mr. **Wilson**. No, sir, excuse me, was that question asked of me?

The **Chairman**. Either one. I addressed it to both of you.

Mr. **Blalock**. I defer to you.

Mr. **Wilson**. It just happens, Senator, that I have something prepared on this. If you will allow me, I would like to give this handout to the committee, because we have specific examples here on this subject.

We have a 16 cents per pack excise tax on cigarettes, and now it is alleged that the U.S. Government collects less than that amount per pack. This allegation has no basis in fact. Tobacco companies pay 16 cents per pack excise tax on cigarettes every time a pack of cigarettes leaves the bonded warehouse. We incur a liability for and must pay the U.S. Treasury the 16 cents excise tax. It is true that we treat the excise tax as a deduction in determining our Federal income tax; however, this deduction merely acknowledges that excise taxes are a cost of doing business no less than any other cost, and that the Federal income tax, as mandated by the Constitution, must tax only net income, not gross revenues.

You must remember that because of the 16 cents excise tax imposition, we must try to price our product to produce a profit, taking this excise tax cost as well as all other costs into account. The increased price, which includes the full 16 cents excise tax, is, itself, subject to the Federal income tax. To impose a tax on income which is created only because of the excise tax imposition without an offsetting deduction would be manifestly unfair.

The present law allowing deduction of excise taxes merely acknowledges this inequity which the absence of this deduction would create.

I have an example here, Senator, which shows that at a 40-percent tax rate, that we are paying an income tax on a pack of cigarettes of 9.2 cents in both instances, with an excise tax or without an excise tax.

I would like to provide this to the committee, if you would like to have it.

The CHAIRMAN. We will take it, and I will put it in the record.

[The information follows:]

RJR

R. J. Reynolds Industries, Inc.
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J. Tylee Wilson
Chairman
Chief Executive Officer

Telex
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April 22, 1986

The Honorable Robert Packwood
United States Senate
257 Russell Senate Office Building
Washington, D. C. 20510

Dear Senator Packwood:

Thank you for the opportunity of appearing before your committee to present our views on the excise tax proposals.

I remain concerned about a number of points raised at the hearing. In particular, I am still unable to ascertain why you have concluded that the federal government receives something less than the 16-cents per pack federal excise tax which our company dutifully remits to the government every two weeks. I must therefore conclude that you must be laboring under certain misconceptions concerning our business practices.

For instance, it may be that you believe that less than 100% of the federal excise tax is passed on to our customers. Let me assure you that we do, in fact, pass 100% of the federal excise tax on to our customers by raising our prices by the amount of the tax. This increased price is subject to the federal income tax at the 46% rate. The deduction for the excise tax merely offsets the taxable income created by this federal excise tax "pass-through". Without a doubt, if there were no 16-cents excise tax, we would lower our prices by 16-cents per pack, thereby reducing our taxable income by that amount. The existing law deduction for excise taxes simply allows us to pass the excise tax on to our customers without artificially creating taxable income for us when no income in fact exists.

It may be that in certain industries, manufacturers subject to a federal excise tax are unable to fully pass through the tax, with the result that the excise tax deduction exceeds the taxable income generated by any excise tax induced price increase, thus arguably reducing the net income tax which such company would pay in the absence of the excise tax imposition. In that regard, I would make the following observations:

- This is not our case--we pass along 100% of the federal excise tax to our customers.

- For manufacturers which are unable to fully pass through the tax, they have suffered a real loss of income which must be taken into account by the income tax law. The present law deduction for excise taxes paid is an appropriate mechanism for acknowledging this economic fact of life.

I hope that the foregoing will be of some assistance in clarifying my position on this matter. In that regard, there is attached hereto a copy of the "Explanation" of this issue which we submitted to your committee at the April 21 hearing. If you feel that further elaboration upon or discussion of this issue would assist you in your deliberations, I or a member of my staff would be happy to meet with you or your designee to provide such assistance as we can.

Cordially,

Ty Wilson

J. Tyler Wilson

JTW:db

CC: Senate Finance Committee

EXPLANATION OF 16 CENTS PER PACK EXCISE TAX PAID ON CIGARETTES VERSUS AN ALLEGED LOWER AMOUNT RECEIVED BY THE U.S. GOVERNMENT

We have a 16 cents per pack excise tax on cigarettes. It is alleged that the U.S. government collects less than that amount per pack. This allegation has no basis in fact. Tobacco companies pay 16 cents per pack excise tax on cigarettes. It is true that we treat the excise tax as a deduction in determining our federal income tax. However, this deduction merely acknowledges that excise taxes are a cost of doing business no less than any other cost, and that the federal income tax, as mandated by the Constitution, must tax only net income, not gross revenues. You must remember that, because of the 16 cents excise tax imposition, we must try to price our product to produce a profit, taking this excise tax cost, as well as all other costs, into account. The increased price is itself subject to the federal income tax. To impose a tax on income which is created only because of the excise tax imposition would be manifestly unfair. The present law allowing deduction of excise taxes merely acknowledges this inequity which the absence of this deduction would create.

EXAMPLE A

Assuming there were no federal excise tax (FET):

Selling Price (assuming no FET)	$1.00/pack
Cost of Sales	.80/pack
Net Income	.20/pack x 46% rate
Income Tax	$.092/pack

EXAMPLE B

But, because there is an federal excise tax

Selling price ($.16 FET)	$1.16/pack
Cost of Sales	.80/pack
FET	.16/pack
Net Income	.20/pack x 46% rate
Income Tax	$.092/pack

The CHAIRMAN. Let me pursue it further. You are saying we collect the 16 cents. The Joint Tax Committee, upon whom we rely for advice, said you can levy a 16-cent tax but, because of the income tax deduction, you cannot count on net revenues of 16 cents a pack. Is that correct?

Mr. WILSON. Well, as I think I made comment on in our statement, our price has been increased to take that into account, sir.

The CHAIRMAN. You lost me there.

Mr. WILSON. Yes; we are increasing our price 16 cents per pack to make an adjustment, and paying income tax on that increased price.

The CHAIRMAN. I understand that.

Mr. WILSON. So the Government ends up with the same amount of money under either instance. You would get, at a 46-percent rate if we used that assumption, which happens to be our rate, you would get 9.2 cents a pack tax, income tax, plus the 16 cents excise tax.

The CHAIRMAN. I am totally confused now.

Mr. WILSON. Plus 16 cents. I believe my advisers are in support of what I just said.

Senator, the example is on the paper. It might be easier to look at that than have me try to explain it, because I'm no tax expert.

The CHAIRMAN. Let me ask it once more, because obviously there is a difference of opinion, then. If there are 100 million packs of cigarettes sold in 1 year and the tax is 16 cents, the Federal Government, net, should collect $16 million, correct?

Mr. WILSON. Yes, sir. The Government will collect $16 million in excise taxes, plus an additional $9.2 million in income taxes on that 100 million packs of cigarettes.

The CHAIRMAN. And will we do that by levying a 16-cent tax? This is net, total.

Mr. WILSON. Yes, sir; the moment a cigarette leaves the factory, you are paid the tax, 16 cents a pack.

The CHAIRMAN. So that the Federal Government's net revenues because of that will increase $16 million?

Mr. WILSON. Well, if you assumed the tax was fully passed on to the consumer as we do in fact pass it on.

The CHAIRMAN. Mr. Oster.

Mr. OSTER. Senator, I think I would have to disagree with Mr. Wilson. The situation would be analogous to the deductibility of gasoline excise taxes on one's income tax return. If the excise tax is raised on cigarettes, the tobacco industry, Mr. Wilson, would in fact declare it as an additional operating expense, and the net yield to the Federal Government, to the Treasury, would be significantly less.

I have seen the estimates by the Joint Committee on Taxation, and they suggest that the yield would be somewhere in the range of about 75 percent of the increase in the excise tax.

The CHAIRMAN. Mr. Wilson, let me ask you a last question. Here I am quoting from the Congressional Budget Office. The Congressional Budget Office shows that last year the combined burden of Federal and State cigarette taxes as a percentage of the price of a pack of cigarettes dropped from about 50 percent in 1955 to 32 percent. Is that correct?

Mr. WILSON. I have no data, Senator, that would refute that, at least not with me today.

Mr. MYERS. Senator, may I just add to that, too?

The CHAIRMAN. Yes.

Mr. MYERS. The Department of Agriculture has just issued a report that indicates that not only are those facts accurate, but that in 1985 that percentage dropped further to 29 percent. So, in just the last decade we have a decline from 36 percent to 29 percent, a rather precipitous drop.

Mr. WILSON. Senator.

The CHAIRMAN. Mr. Wilson.

Mr. WILSON. Thank you, sir. We are talking Federal in that example.

The CHAIRMAN. No, well, I don't know about his, but I was talking Federal and State in mine.

Mr. WILSON. For Federal, State, and local, our data would suggest 50 percent of the final selling price ends up in the hands of tax collectors, somewhere or other.

Mr. OSTER. That was true, Senator, in 1954. However, my figures suggest that the combined take of Federal and State excise taxes in 1984 is only about 32 percent.

The CHAIRMAN. Well, that is the exact figure, 31.8, that I have from the Congressional Budget Office.

Mr. OSTER. Those are the same as my figures.

Mr. MYERS. In the Department of Agriculture figures that I quoted you, it included all excise taxes.

The CHAIRMAN. And in 1985 it would have been down slightly.

Mr. MYERS. Down to 29 percent.

The CHAIRMAN. Other questions?

Senator DANFORTH. Yes.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Do all of you agree that an increase in the excise taxes affects cigarette consumption?

Mr. OSTER. I do.

Mr. WILSON. I certainly agree, Senator.

Mr. MYERS. I think we all do, Senator.

Mr. WILSON. It declines.

Senator DANFORTH. And therefore, the argument that, "Well, an excise tax is just passed on to the consumer"—it is more than just passed on to the consumer; an excise tax increase does reduce sales of the commodity on which there is an excise tax?

Mr. OSTER. Unquestionably.

Mr. WILSON. Absolutely right, sir. The last time that the excise tax was increased, in 1983, as you recall it was doubled to 16 cents, the industry volume decline was 6 percent, followed by 2 years of 2 percent declines. We would estimate the same this year. The industry will not recover from that event.

Senator DANFORTH. I don't want to just get into a roundtable on it, but as I understand it, that is the consensus.

I want to ask one other question of Dr. Oster and Mr. Myers.

You are each representatives of organizations that are opposed to smoking, is that right?

Mr. MYERS. I am.

Mr. OSTER. I am not.

Senator DANFORTH. Oh. What are you, Mr. Oster?

Mr. OSTER. I am a health and medical economist with a research organization in Boston, and I have done quite a bit of work on the economic impact of smoking and smoking-related diseases.

Senator DANFORTH. Well, do you have a view on smoking?

Mr. OSTER. I have many views on smoking.

Senator DANFORTH. But other than a personal view. You are not here to represent any view, pro or con, on smoking?

Mr. OSTER. I am not here to represent any view, pro or con, with respect to smoking.

Senator DANFORTH. But, Mr. Myers, you are, correct?

Mr. MYERS. I certainly am.

Senator DANFORTH. All right. Well, let me ask you this: In your opinion, is it smoking itself that is the problem, or is it smoking in excess? That is, is moderate smoking something that is permissible? Well, everything is permissible; but, as far as you are concerned, is there a distinction between smoking in excess and smoking in moderation?

Mr. MYERS. Unlike with alcohol, it is the very act of smoking which is harmful to health. There is no such thing as a safe level of smoking. To the best of our knowledge, any smoking increases your risk of lung cancer, heart disease, and a variety of other diseases.

Senator DANFORTH. And that, in your opinion, is the difference between smoking and alcohol?

Mr. MYERS. It certainly is.

The CHAIRMAN. Other questions?

[No response.]

The CHAIRMAN. If not——

Senator SYMMS. Mr. Chairman.

The CHAIRMAN. Oh, I'm sorry. Senator Symms.

Senator SYMMS. Mr. Chairman, I would like to ask Mr. Myers just one question.

If the tax system is to be used to curtail the consumption of some products because of allegations about their being injurious to health, and so forth, are there other products in addition to tobacco that that should be extended to?

Mr. MYERS. Let me suggest, Senator, that cigarettes are unique in our society. Cigarettes are the only product that, when consumed as intended by the manufacturer, cause the diseases about which we are concerned.

Further, let me add, there is no product about which we know more scientifically as it relates to the health consequences of that product than cigarettes.

So, what this committee does for cigarettes can be looked at in isolation. We are talking about a human toll for cigarettes alone that far exceeds anything else in terms of a public health hazard in this country.

Senator SYMMS. So, you say there is nothing else? You would just limit it to cigarettes?

Mr. MYERS. What I am saying to you is that I am concerned about the problems of smoking. I am not taking a position with regard to other products. But I am saying to you, also, that cigarettes are unique in our society.

Senator SYMMS. Does anybody else want to comment on that?

Mr. WILSON. Yes, Senator. On behalf of the tobacco industry, I would just like to say that Mr. Myers' position, as far as we are concerned, is totally unfounded. And obviously, we do not agree with it.

Mr. BLALOCK. There are studies to the contrary of some of the conclusions that Mr. Myers and others have stated. I think it is unfortunate the committee did not have a chance to hear some of these.

We looked at this bill as strictly a revenue bill, not as a bill designed for behavior modification, which is what Mr. Myers is talking about.

As an example of the impact on our industry, we have a clear one as to what it will do to farmers from the doubling of the excise tax in 1982. The following 3 years the Stabilization Corp., which runs a loan program for tobacco, received the largest amounts of tobacco in the history of the program. Had it not been for the reform bill that Senator Packwood and others were instrumental in getting through, I think the Tobacco Program would have gone bankrupt in 1986.

Mr. MYERS. Senator Symms, may I just comment on that? Mr. Blalock is shooting his arrows in the wrong direction; he should be shooting them a little bit to the right toward Mr. Wilson. Tobacco farmers have suffered difficult times, but the culprit lies in the decision of the cigarette manufacturers to dramatically increase the level of tobacco they imported from abroad, up to a third of each cigarette. And further, the 1982 example is a good one. Between August 1982 and June 1983, cigarette manufacturers increased their prices six times. That increase was a full 20 percent over and above any excise tax increase.

The CHAIRMAN. Any other questions?

[No response.]

The CHAIRMAN. If not, gentlemen, thank you very much.

Next, let us take Mr. F.A. Meister, Mr. August A. Busch, Mr. Tony Debevc, and Dr. Michael Jacobson.

Senator SYMMS. Mr. Chairman, I would like to ask unanimous consent to place in the record a statement by a very distinguished former official at the Treasury Department, Under Secretary of the Treasury Normal Turee.

This statement was published on March 24, and it is a very adroit criticism of the excise tax provisions in the markup vehicle. The publication, "The Economic Policy Bulletin" of the Institute for Research & Economics of Taxation, is well worth the committee's attention, and I would like to ask unanimous consent that Dr. Turee's statement will be placed in the record at the appropriate place.

The CHAIRMAN. Without objection.

Mr. Meister, why don't you go right ahead?

Mr. MEISTER. Thank you.

[Dr. Turee's statement from "The Economic Policy Bulletin" follows:]

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CHAIRMAN PACKWOOD'S PROPOSED EXCISE TAX AND TARIFF CHANGES

SUMMARY

Senate Finance Committee Chairman Packwood's proposed excise tax and tariff changes would intensify the seriously adverse economic effects of these taxes. These changes would impair productivity, cost jobs and income, and waste our economic resources.

Selective excises not only burden purchasers of the taxed products and services, even more seriously they distort the use of production resources, resulting in less productive use of labor and capital. Those supplying these production resources sustain losses in income and wind up in production activities in which they are less well rewarded in real terms. The entire economy suffers from the dislocations resulting from selective excises.

If implemented, Senator Packwood's proposal to tax alcohol, tobacco, and motor fuels on the basis of their prices rather than, as at present, on the basis of physical quantities would result in increases in these taxes as their prices rise. Under present law, the adverse effects of these taxes declines as the prices of the taxed items increase. This erosion of the economic disadvantages of selective taxes would be lost as a result of the proposed change.

By denying the deductibility of Federal excise taxes in computing a business's taxable income, the true rate of these excise taxes would be increased, thereby intensifying their adverse effects on the economy. At the same time, nondeductibility of these taxes would increase the income tax rate on the true net income of the affected businesses. Instead of contributing to attainment of a level playing field, ostensibly a major objective of the current tax reform effort, this change would riddle the playing field with tax differential potholes.

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.

Even worse, the Packwood proposal would attribute taxable income at least equal to their excise tax liabilities to businesses even if they had no taxable income, indeed, even if they sustained substantial losses. Taxing phantom income would be the ultimate in an Orwellian 1984 tax policy.

The proposed excise changes would raise an estimated $77 billion in tax revenues over the first five years, offsetting a significant part of the revenue losses from tax rate reductions, increases in the personal exemptions, and other revenue-losing income tax changes. The proposed excise tax changes would be a major element in a tax redistribution program, with those supplying the labor and capital services used in producing excise-taxed items bearing additional taxes to provide lower taxes for others.

The proposed excise tax changes would be a large step backwards in tax policy. They should be deleted from the tax reform package.

Introduction

In the summary of his tax reform proposals presented on March 13, 1986, Senate Finance Committee Chairman Robert Packwood recommended a number of major and drastic changes in the present income tax treatment of excises. Chairman Packwood proposed to disallow the deductibility of all excises and tariffs by business income taxpayers; he also proposed to impose the excise taxes on alcohol, tobacco, and motor fuels on the value of these products, i.e., on an ad valorem basis, rather than, as at present, on the basis of some physical volume measure of them, i.e., on an ad rem basis, and to raise the rate of the excise on wine to make it equivalent to that now imposed on beer.

These measures would increase the revenues from excise taxes and tariffs by an estimated $77 billion over the first five years in which these changes would be effective. Roughly $62 billion would come from the excise taxes and about $15 billion from the nondeductibility of tariffs. These revenue additions would be among the largest of those proposed in the Chairman's tax reform package. Because that package is alleged to be revenue neutral over the five-year revenue projection period, these additional revenues presumably are to be used to help offset the revenue losses estimated to result from the proposed reductions in individual and corporate income tax rates, the increases in the personal exemptions and standard deductions for individual taxpayers, and from a number of other proposed income tax revisions. As a result, these additional excise tax and tariff revenues would be one of the major elements in effecting a substantial redistribution of tax liabilities througnout the U.S. economy.

Just as significant, this huge increase in excise and tariff revenues over the amounts that would be realized under present law during the revenue projection period would be a sharp reversal of the trend of recent years. For many years, Federal budget receipts from excise taxes and tariffs have accounted for a decreasing fraction of total Federal budget receipts. In fiscal year 1940, excise tax and tariff receipts were 32 percent of all Federal budget receipts. Excise tax revenues increased in absolute amount during World War II, both because many additional excise taxes were levied and because the aggregate volume of economic activity expanded rapidly under the wartime forced draft economic conditions. Excise taxes and tariffs contributed a sharply declining share of total Federal tax revenues, however, because the sharp increase in income tax liabilities very greatly exceeded the growth in excise tax revenues. Between fiscal years 1950 and 1985, Federal excise tax and tariff revenues have fallen from 19.4 percent of total Federal budget receipts to 6.6 percent. In the absence of the changes proposed by Chairman Packwood, the relative contribution of these revenue services, it is estimated, would fall to 4.4 percent in fiscal 1990. Chairman Packwood's proposed excise tax and tariff changes would bring this wholesome trend to an abrupt halt. Over the five-year projection period, his proposed changes would boost the share of total tax revenues accounted for by excise taxes and tariffs from about 5.0 percent to about 6.6 percent.

Against all significant criteria of good tax policy, the proposed excise tax and tariff changes would be a major step backward. The excise taxes and tariffs in the Federal revenue system are selective taxes; they are imposed at differing rates on selected products and services, rather than being levied at the same rate on all of the products and services produced and sold in the economy. As selective taxes, they have seriously adverse effects on the economy. The changes proposed by Chairman Packwood would intensify these adverse economic effects, impair the economy's growth, interfere further with the most productive use of our production capability, and result in less real wages and less of all other income throughout the economy, compared with the levels that would prevail if these excise tax changes were not enacted. The redistribution of tax burdens that would result from these tax changes would be substantial; there is no reason to believe that these shifts in tax burdens would conform with any acceptable standards of either economic efficiency or tax fairness. If the current tax reform effort is to extend its reach beyond the income tax, it should seek to reduce, if not completely eliminate, selective taxes, not to increase their weight in the Federal tax system.

The Basic Economics of Excise Taxation

Selective excise taxes are guilty of a number of serious fiscal and economic crimes. The outstanding attribute of a selective excise tax is that it raises the cost of the product, service, or activity on which it is levied relative to the costs of products, services, and activities not subject to such taxes. The consequence is that relative costs and prices differ from those that would be determined in the market place by the conditions of supply and demand. Selective excise taxes, in other words, distort the relationships among the market's valuations of goods and services.

These changes in relative market prices, in turn, lead to changes in the composition of output and of purchases. If one may appropriately assume that free markets provide price and cost information that leads to the most effective use of production capability and a composition of output that best and most economically satisfies our demands, then the price-and-cost-distorting effects of selective excises must result in a less effective use of our production capability and a less satisfying market basket of goods and services.

These relative cost and price distortions result because selective excises drive a wedge between the price a buyer must pay for a product or service subject to the tax and the price that the seller of the taxed product or service receives. An excise tax imposed on a product or service raises the cost of producing and selling any given amount of it. If the producer tries to raise the price of the product or service to cover this additional cost, purchasers will buy less of it. With a smaller volume of sales, clearly, total production of the taxed product or service must sooner or later decline. A smaller volume of output, of course, means that less production inputs are used by producers of the taxed products or services. As a consequence, total payments for production inputs decrease. Ultimately, the selective excise shows up in the form of higher market prices for the taxed product or service, a smaller volume of purchases of these products or services, hence a smaller volume of their output, less production inputs dedicated to their output, and reduced incomes to those supplying these production inputs.

A simple example may be helpful in understanding the incidence of selective excises. Suppose a widget manufacturer can produce 100 widgets at a cost of $10 per widget and requires a markup of $1 per widget to earn a profit sufficient to attract and maintain the capital resources needed for the most efficient, least costly production of 100 widgets. Suppose, also, that he can sell 100 widgets at a price of $11 per widget. If an excise of $1 per widget is levied on the manufacturer, raising his total production costs to $11, he would have to raise his price to $12.00 or reduce his markup. To the extent he raises his selling price, inclusive of the excise tax, above $11, he must be prepared to suffer a reduction in sales volume. Very likely, as he reduces his sales volume, his unit production costs will decline. At some lower volume, presumably, he will be able to sell that volume of widgets at a price sufficient to cover his production costs, his required markup, and the selective excise. Suppose that price is, say, $11.50, leaving him $10.50 after the selective excise is remitted to the government with which to pay for the labor and capital services, energy supplies, raw materials, etc., needed to produce, say, 90 widgets that people are willing to buy at a price of $11.50. The end result is that widget buyers now spend $1,035 on widgets instead of $1,100. Widget producers, however receive only $945 of the $1,035, the remaining $90 going to the government. There is now $55 less income --- wages, salaries, dividends, etc. --- available to those who participate in widget production.

Notice what the imposition of the selective excise has done. It has led widget buyers to cut their purchases and to reduce their total outlays for widgets, presumably allocating more of their incomes to the purchase of other products and services. It has also led widget producers to cut back on their output, hence on their purchases of the production inputs that go into manufacturing widgets; total payments by widget producers for these production inputs are also reduced. To be sure, the price of widgets has gone up by some fraction of the selective excise tax imposed on them, and widget buyers have been induced thereby to shift to some other market basket of products and services than the one they found most satisfying before the excise tax was imposed; for widget buyers, one must presume, the new market basket is somewhat less satisfying than the original one. But the major initial burden of the selective excise tax on widgets clearly has been borne by those supplying the production inputs to widget manufacturers.

In fact, the story about the incidence of the selective excise doesn't end here. Many of the production inputs used in manufacturing widgets may be more or less specialized in widget production, at least for some period of time. To the extent that the amount of these production inputs used in widget manufacturing is reduced as a result of the levying of the excise tax, they are likely to remain idle until they can be adapted to other production uses. The widget employees who are let go when widget output is reduced in response to the imposition of the excise may be out of work for some time until they acquire new skills or locate other jobs in which they can use their existing skills, albeit less productively than in widget manufacturing. In time, presumably, the production inputs released from widget manufacturing will be used in other lines of production. In some cases, this will occur only if the rates of payment for these inputs and for all of the inputs in these other production lines are less they otherwise would be.

As widget purchasers change the composition of their purchases, buying fewer widgets and a larger volume of other products and services, prices and volumes of output of these other products and services are likely to increase, requiring larger amounts of the production inputs used in their production. Of course, reallocating production inputs from one use to another is not costless. The costs of changing the use of production inputs should be included among the burdens of selective excises. Sooner or later, then, the selective excise on widgets also shows up in distortions of outputs and inputs and in incomes elsewhere in the economy.

Customs duties create similar distortions. These taxes make imported raw materials, imported manufactured inputs, imported consumer goods, etc., appear artificially expensive. Assuming that foreign suppliers are unwilling to absorb all of the tax themselves, the tariffs handicap American buyers -- producers and consumers -- by arbitrarily raising the costs of imports, denying Americans some of the advantages of foreign trade. American consumers are hurt when they buy imported products bearing tariffs because the tariffs tend to increase the prices of those products. Consumers will also be hurt when they buy American products that contain some imported inputs because the tariffs raise production costs; some part of this cost increase ultimately shows up in product prices.

The distortions of output and of input uses and the losses in consumer satisfactions that are imposed by the imposition of selective excises are serious and substantial economic burdens. Because of the use of selective excises in the nation's tax system, the economy's production capability is less productively used than it otherwise would be. Selective excises, in other words, are fiscal engines of waste. Wasteful uses of production inputs reduce the capacity of the economy to grow over time. In terms of the economic efficiency and growth goals of tax policy, therefore, selective excises should not be included in the nation's tax system except for the few cases in which they might conceivably offset structural deficiencies in the market system. Because those deficiencies are extremely difficult to identify and to measure, it is highly unlikely that selective excises appropriate for their correction could be designed with reasonable accuracy. There are, therefore, virtually no appropriate uses for selective excise taxes.

Selective excises taxes also rank very low in terms of the fiscal criteria of "good" taxes. For the most part, these levies escape the painful awareness by those who must ultimately bear their burden. But hidden taxes are, for the very fact of their obscurity, bad taxes. If taxes and tax burdens are to enter into democratically determined decisions about how much of the economy's production capability is to be made available to government, people must be aware of these taxes and painfully conscious of their burden.

Assessment of the Proposed Changes in Excise Taxes and Tariffs

Chairman Packwood's proposed revisions of excise taxes and tariffs should be evaluated in the light of the basic attributes of these levies and their assessment in terms of fundamental tax criteria. On these grounds, the proposals score very poorly, indeed.

Although little reliance need be or should be placed on the estimates of the revenue consequences of particular tax revisions, the magnitude of the estimated revenue gains from Chairman Packwood's excise and tariff revisions are surely strongly indicative of the severity of these proposed changes. Virtually on the grounds of these revenue estimates alone, one might well conclude that the proposed changes would significantly aggravate the economic disabilities of the present selective excise tax and tariff system. If the revenue gain of $77 billion over the five-year projection period is deemed to be a reasonable estimate, these proposed revisions would increase revenues from these sources by about 32 percent over the amounts projected for the period under present law. Increasing the average weight of these taxes by close to one-third is moving in the wrong direction in the light of any appropriate objective of tax reform.

Apart from this consideration, the particulars of the proposed revisions are themselves highly objectionable. Arguments may be advanced in the abstract for preferring either an ad valorem or ad rem assessment of selective excises. As a practical matter in today's fiscal and economic environment, the proposal to shift from an ad rem to an ad valorem basis for the excises imposed an alcoholic beverages, tobacco, and motor fuels should be seen as a means for obtaining higher tax yields from these products over time, insofar as their prices rise, without having to rely on explicit legislative enactment of higher tax rates.

When imposed on an ad rem basis, selective excises' effective rates decline, in real terms, as the market prices of the taxed products and services increase. This erosion of the real effective rates of selective excises serves to moderate their adverse economic consequences. By converting these taxes to ad valorem imposts, this reduction in their real effective tax rates is averted, and their adverse economic consequences are maintained. Considerations of tax requirements for economic growth and efficiency militate strongly against switching these taxes to an ad valorem basis.

As objectionable, indeed if not much more so, is the proposed repeal of the deductibility of selective excises and tariffs from gross income in determining the taxable income of business income taxpayers. Denying deductibility of these levies would increase their weight and their adverse economic effects

Excise taxes and tariffs, no less than wages, energy supply costs, capital costs, raw material costs, etc., must be taken into account as costs associated with the production and sale of the taxed products or services. No less than any other production and sales cost, excise taxes enter into a business' decisions about how much of what to produce and to sell at what prices.

The income tax imposed on business net income has always provided for the deduction of all costs incurred in the processes of production and sale, although, to be sure, the manner in which these deductions have been allowed has at times been changed and often has not accorded with the requirements of neutral tax treatment. But to deny the deductibility of excise taxes and tariffs would be to distort the measurement of the net income produced by a business just as much as would denying the deductibility of payrolls, raw materials, etc.

Present law quite correctly includes Federal employment taxes as part of employees' compensation and as payroll costs, fully deductible by the employer business in determining taxable income under the income tax. These employment taxes are, in economic terms, selective excises, virtually identical in their basic economic attributes to any other excise tax imposed by the Federal government. If there were any economic or fiscal justification for repealing the deductibility by a business of, say, the gasoline excise tax, there would be no less justification for repealing the deductibility by business of employment taxes. Repeal of employment tax deductibility would, obviously, have an enormously adverse effect on employment costs, on employment, and on labor income, as well as imposing wrenching distortions of the composition of economic activity. Repealing the deductibility of the Federal selective excise taxes would have very much the same sort of devastating economic effects, even if somewhat less severe in magnitude.

Because the excise taxes in the Federal revenue system are not applied uniformly to all production and sales of all products and services, but are, on the contrary, highly selective, denying the deductibility of these taxes would result in grossly differing effects among businesses. Businesses involved heavily in producing and selling products and services subject to selective excises, obviously, would find the net-of-tax costs of their operations increased relative to those of other businesses. The prices of their outputs would have to go up and the volume of their output would have to contract relative to that of other businesses, as would their employment of labor and capital services and other production inputs. Repealing the deductibility of excise taxes and tariffs in measuring taxable income for income tax purposes would intensify the distorting effects of these levies.

Nondeductibility of Excise Taxes: Effects on True Rates of Income Tax and Excise Taxes

	Present Law	Packwood Proposal	
		Income Tax Effect	Excise Tax Effect
Gross Receipts	$100	$100	$100
Less: Cost of goods sold	55	55	55
Gross profit	45	45	45
Less: Other expenses	30	30	30
Excise tax:			
Actual	5	5	5
Equivalent	5	5	7.69
Deductible	5	-	7.69
Taxable income	10	15	7.31
Income tax @ 35 percent	3.50	5.25	2.56
Total taxes, actual	8.50	10.25	10.25
Income tax as percent of actual net income of 10	35	52.5	25.6
Excise tax as percent of:			
gross receipts	5	5	7.69
actual net income	50	50	76.9

Disallowing deductions for excise taxes and tariffs, moreover, would also increase the rate of income tax actually falling on business incomes correctly measured as net of all costs incurred in the production of that income. Equivalently, the repeal of excise tax deductibility would increase the effective rate of these excise taxes. These effects are highlighted in the hypothetical case summarized in the following table.

Repealing excise tax deductibility would raise the income tax liability in this case by 50 percent, from $3.50, under present law, to $5.25, or from 35 percent to 52.5 percent of the actual net income of $10. Total excise tax plus income tax liabilities would increase from $8.50 to $10.25. If deductibility of excise taxes were retained, the same increase in total tax liabilities would result if the excise tax were $7.69 instead of $5.00, or nearly 54 percent more.

The extent of these hidden income tax rate increases would depend, obviously, on the amount of Federal excise taxes and tariffs paid by a business in relation to its other costs of production and sales. In view of the very substantial differences in the extent to which differing businesses incur these imposts and in the weight of these taxes in their total costs, repeal of the deductibility of excises and tariffs would differentially increase from one business to another the actual income tax rates on correctly measured taxable income.

If the income tax is not to fall with differing weights on equally profitable business operations merely because of differences in the extent to which these businesses are exposed to selective excise taxes, taxable income must exclude these excise taxes (indeed, all taxes paid by businesses). Failure to exclude these selective excises from taxable income means that the income tax itself will intensify the distortions imposed by the selective excises.

Chairman Packwood's proposal to deny the income tax deductibility of excise taxes is confined to Federal excises. Excise taxes imposed by other governments in the United States presumably would continue to be deductible in computing business net income for Federal income tax purposes. Distinguishing between a selective excise imposed by a state government and an identical or similar excise imposed by the Federal government in terms of economic effects or the most rudimentary principles of tax fairness must boggle the mind. It is impossible to find any basis in reason for disallowing the deduction of excise taxes imposed by one level of government while continuing to allow the deduction of the same or similar taxes imposed by other governments. This is certainly not to suggest that the excise taxes imposed by other governments should be disallowed as well; even if reason, logic, and basic principles of taxation did not preclude this result, the new fiscal burdens that would be imposed on state and local governments by H.R. 3838 or Chairman Packwood's proposed modifications of that legislation should do so.

Much has been made during the current tax reform effort of the desirability of providing a level playing field in the tax treatment of businesses with differing kinds of operations, differing production inputs, differing time patterns in incurring costs and realizing incomes, etc. Many of the proposals that have been advanced with this purpose in mind would, to be sure, miss the mark; many, indeed, would tilt the playing field against saving and investment and riddle that playing field with the potholes of differing business tax burdens on the basis of the kinds of production facilities they use. But these misses, for the most part, are mischances, the results of failure to understand the effects of various tax provisions in present law and in the various reform proposals. The proposed disallowance of deductions for Federal excise taxes and tariffs can't be excused on these grounds.

By far the most radical, indeed, astonishing of the Chairman's excise tax proposals is the one requiring businesses to pay income tax at the top corporate rate on taxable income deemed to be at least equal to their excise tax liabilities, irrespective of the actual amounts of their net incomes. This presumably means that, merely by virtue of the fact that it is liable for payment of excise taxes, a company with a net operating loss, even one many times larger than its excise tax liability, would have to pretend that it had positive taxable income at least equal to the excise taxes it must pay and to pay income tax on this phantom taxable income. This imputation of taxable income and assessment of income tax liability where no taxable income exists is the Orwellian 1984 of tax policy. It could well serve as a disastrous precedent for more generally assessing tax liabilities without any reference to economic realities.

It seems clear that these proposed excise tax changes were advanced not in the interests of improving these levies nor in the interests of true reform of the income tax. They appear to have been advanced merely as devices for raising some substantial part of the revenues needed to offset the very large revenue losses that other features of the tax reform program would entail.

These revenue raisers, moreover, are presumed to be relatively painless; because they would not fall directly on individual income taxpayers as such but on business income taxpayers, popular resistance to these tax increases is probably deemed to be slight. The notion appears to be that only directly affected businesses would be injured by denying deductibility of Federal excises for income tax purposes. Although this is clearly not the case, although the economy as a whole will sustain the losses imposed by aggravating the distortions imposed by selective excises, these losses are not readily apparent and measurable by the average individual. The fact that they escape our awareness in no way abates the harmful effects of Chairman Packwood's proposals.

Some may attempt to justify raising the excise tax cost of the production and consumption of tobacco products and alcoholic beverages on sumptuary or health grounds. If a good case could be made for transferring responsibility from the individual to the government for determining how much of what kind, if any, of these products to consume, that fundamental decision surely should not be made in the shadow of income tax reform. If the Congress wants to raise the real rates of all of the present customs duties, it should face the issue of intensified protectionism openly and squarely, not slip it under the tax reform rug. If a case could be made for gearing motor fuels excise taxes to the market value of motor fuels, that decision deserves to be made on its own merits and in the open, not hidden from view by the overshadowing arguments concerning income tax reform and the most effective and desirable ways of financing the revenue losers in the income tax reform package.

In this connection, the issue surely should be forcefully addressed whether producers and users of the products and services now subject to Federal excise taxation and tariffs should bear so large and disproportionate a share of the burden for financing the rate reductions and other revenue losers in the income tax reform effort. Enhancing the real burden of selective excises and tariffs certainly cannot be justified on its own merits. Asking some part of the population to pick up the chips for others in order to provide tax reductions and to do so through the proposed excise and tariff tax changes amounts to a kind of mindless redistributive tax policy. Why should people who work in truck manufacturing, telephone communications, airlines, tire manufacturing, tobacco, alcoholic beverage, and other excise-taxed industries pay for the tax reductions of those otherwise employed? If tax policy is to be applied to the questionable assignment of redistributing income and wealth among the population, at least it should be done with some clear notion of who are to be the income transferees and who are to be the transferors.

Apart from these issues, the likely economic effects of the proposed excise tax and tariff changes should be given substantial weight in the evaluation of these proposals. As already urged, the proposed revisions, by increasing the true rates of the excise taxes and tariffs, and differentially increasing income tax rates, would significantly enhance excise tax distortions of relative prices and costs, of the allocation of production inputs among their alternative uses, and of the composition of total output and consumption. These distortions, although difficult to perceive, to identify, and to measure are nonetheless real; the higher the true rate of the excise taxes and tariffs, the more severe these distortions become.

For this reason, Chairman Packwood's proposed excise tax and tariff revisions would, if enacted, seriously impair the efficiency with which the economy would operate. Production activity would be less productively undertaken. The loss in productivity would show up not merely in displacement of employees from their more productive to less productive jobs, but in loss in employment, at least during the transition period, and loss in real wages. Because some of the selective excises rest on products and services used throughout the business sector, moreover, the increase in their true rates resulting from the proposed changes would tend to raise production costs very widely throughout the economy. The adverse effects of these increases in costs, though not readily apparent, would nevertheless be real and would be in the form of less output, employment, and real income than would prevail if these changes were not made.

However useful the purposes to which the additional revenues to be derived from these excise tax changes might be deemed to be, they surely should not be undertaken without a thorough assessment of the costs they would inevitably impose. These costs are not readily measured, but they would be incurred as a result of the enactment of the proposed changes. Against any relevant economic and fiscal criteria of tax policy, these costs are excessive. The proposed changes in excise taxes and in their income tax treatment should be rejected.

Norman B. Ture

STATEMENT OF F.A. MEISTER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, DISTILLED SPIRITS COUNCIL OF THE UNITED STATES, INC., WASHINGTON, DC

Mr. MEISTER. Thank you, Mr. Chairman.

I am Fred Meister, president of the Distilled Spirits Council. We believe that the excise tax proposals would be catastrophic. They are the equivalent to massive regressive tax increases of 54 percent, hitting hardest at low- and middle-income families. The proposals are radical departures from well-established tax policy, and as the efficient up-front tax collectors for the Federal Government, not only do we not make any money from the excise tax, but in fact it costs us money since we prepay the tax.

The excise tax proposal's both nondeductibility and indexing would threaten the existence of our industry. If not passed through to the consumer, our industry, from nondeductibility alone, would have to pay $1.8 billion more in taxes per year. That is triple our net income.

Second, each company would face the choice of whether to go bankrupt or pass the tax increase on to the consumers. Whether passed on or not, it will mean $8.9 billion in Federal tax increases on spirits over 5 years. If passed on to the 100 million consumers who use our product in moderation, it could cost $4.6 billion more each year when the consumer steps to the cash register.

Third, the spirits industry sales are down in each of the last 4 years, and we were singled out in the 1984 tax bill for a 19-percent tax hike. Now, on top of that, the excise tax proposal suggests the equivalent of a 54 percent increase. That would be a cumulative increase of 83 percent in our taxes in just 2 years.

Fourth, this bill will result, as written, in the bankruptcy and closing of the doors of thousands of our small businesses. Our products are principally distributed through mom-and-pop liquor stores and taverns. The nondeductibility proposal alone could result in the loss of 23,000 jobs and the possible demise of 10,000 small business establishments. And your staff has provided you with the impact of the States represented on this committee.

Fifth, no industry, we believe, will suffer as much as ours. We are already the most heavily taxed consumer product in the United States. The Federal excise tax alone is already 28.5 percent of the retail price of liquor, as compared to 15.5 for cigarettes, 5.5 percent for beer, and 1.5 percent for table wine. That is because the alcohol in spirits is taxed at a rate 4 times higher than beer and 16 times higher than table wine.

Although expenditures on distilled spirits account for only one-third of alcohol beverages sold in the United States, we pay two-thirds of the total Federal excise taxes collected from beverage alcohol.

Finally, we are equally alarmed by the mysterious and as yet unveiled proposal to adjust the rate of excise taxes on alcohol, tobacco, and motor fuels to reflect price changes. Indexing certainly won't simplify the Tax Code, it certainly won't help fight inflation, and it does penalize a few industries.

Finally, the Canadian experience with indexing taxes is instructive: between April 1981 and September 1984, the Federal alcohol excise tax in Canada was automaticallly indexed to changes in the Consumer Price Index for alcohol beverages. The indexing policy had the following disastrous effects: Federal spirits taxes were raised five times for a total of 54 percent, retail liquor prices increased almost 50 percent, sales fell 20 percent, 3,200 jobs were lost, and, most importantly for this committee, tax rate increases were totally offset by revenue losses.

Because of the unequivocal failure of the policy, the system of indexing was terminated in May 1985.

The liquor industry is traditionally seen as an easy, political hit, a bottomless pit of money. That is not the case. We are a major and a legitimate industry, providing jobs and indeed billions of dollars of revenues to Federal and state treasuries. Like all industries, we feel the ebb and flow of economic tides, and for a number of years we have felt only the ebb. We are at our lowest point.

We do not ask for special treatment. We pay more than our fair share now. Just 6 months ago you substantially increased that share only on liquor. There is a limit on our ability to pay. That limit has already been passed.

The administration spoke this morning about the fact that excises do not keep up with price increases. What was not mentioned is the fact that we pay $3.3 billion to State revenues, and that we have had 63 tax increases at the State level. In the last 5 years alone, 15 of the 20 States of the Senate Finance Committee have increased taxes at the State level on liquor. So, 49 percent of the retail price of our product is now composed of Federal, State, and local taxes.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Busch.

[The written testimony of Mr. Meister follows:]

TESTIMONY OF

F.A. MEISTER

PRESIDENT/CHIEF EXECUTIVE OFFICER
DISTILLED SPIRITS COUNCIL OF THE UNITED STATES

BEFORE

COMMITTEE ON FINANCE
UNITED STATES SENATE

APRIL 21, 1986

TESTIMONY

Mr. Chairman and Members of the Committee:

I am F.A. Meister, President and Chief Executive Officer of the Distilled Spirits Council of the United States representing manufacturers and marketers of distilled spirits.

I appreciate this opportunity to testify and, because my time is limited, I will ask your permission to have additional materials entered into the record. My testimony is supported and endorsed by the National Association of Beverage Importers (NABI).

Today you have heard, and will hear, that the excise tax proposals in the plan before the Committee are catastrophic. I agree. They are, especially for the distilled spirits industry!

1) They are equivalent to massive, regressive tax increases of 54% hitting hardest at low and middle-income families. President Reagan opposes tax increases and I hope he will not ignore the fact that the plan's tax increase proposals are thinly disguised as so-called business loophole closers.

2) The excise tax proposals are radical departures from well-established tax policy. In the pursuit of short-term revenue neutrality for a reform bill, the proposal deviates from the historic and legitimate concept that taxes should be imposed on net income after deducting the cost of goods sold.

3) The excise tax proposals attack and penalize industries which act as the efficient up-front tax collectors for the federal government. The plan imposes an income tax on the excise taxes which we collect and send in to the federal government. Not only do we not make any money from the excise tax, but in fact it costs us money to pay it since we prepay the tax well in advance of receiving payment for our product. In fact, liquor companies paid millions of dollars in 1985 out-of-pocket just to finance the federal excise tax.

These and other arguments are more fully explored in the attachments to my testimony.

Let me take the remainder of my time to tell you what your proposals - both the non-deductibility proposal, as well as the still mysterious and unveiled "ad valorem" or indexing tax hike, will do to our business and our consumers.

First, the excise tax proposals threaten the very existence of our industry. If not passed through to the consumer, our industry would have to pay $1.77 billion more in taxes per year. Since our industry's total net income after taxes is only $500 million per year, we could not continue in business for long under these conditions. How could we exist if our new tax burden was over triple our net income? Even the potential tax benefits available to all businesses in these proposals are far outweighed by the onerous excise tax provisions.

Second, and obviously, each company will face the choice of whether to go bankrupt, or pass the tax increase on to the consumers. Whether passed on to the consumer or not, it will mean a 54% or $8.9 billion federal tax increase on spirits over five years. That could mean a $2.00 increase in the price of a typical bottle.

If there is any question whether the non-deductibility provision is a consumer tax, let me tell you what the Hood River Distillery in Oregon said. Hood River said that it operates on such a low margin of profitability that the new tax burden on them could not be "one bit absorbed by the distiller". The company said that it would be forced to pass on the entire amount to the consumer.

Third, the spirits industry - already in shaky financial shape with sales down in each of the last four years - was singled out in the 1984 tax bill for a 19% tax hike. Now on top of that, the excise tax proposal suggests the equivalent of a 54% increase. That's a total cummulative increase of 83% in our taxes in just two years. There are already substantial sales declines as a result of the 1984 19% federal excise tax increase on liquor. In the last three months of 1985, consumption was down an average of 13.5% in the 20 Finance Committee states due substantially, we believe, to the 19% tax hike which took effect on October 1. That will translate into lost jobs, business shut-downs and, in many cases, less revenues for the states. Can you imagine what the impact of a 54% increase would be?

Fourth, this bill will result in the bankruptcy and closing of the doors of thousands of our small businesses. Our products are principally distributed through liquor stores and taverns. Seventy percent are mom and pop stores employing four or fewer people. Our estimates are that the non-deductibility proposal alone could result in:

- a 25% price increase;
- at least a 10% drop in demand;
- the loss of 23,000 jobs; and,
- the possible demise of 10,000 small business establishments.

In the states of the Senate Finance Committee members, we estimate that 8,150 jobs would be lost and 4,180 businesses might close. These are virtually all small businesses. Here is a breakdown of the Finance Committee situation.

I might add that the 50 states - which rely in a more substantial way on their own individual state excise taxes than the federal government on its FET - would see revenue drop-offs from lost sales to the tune of about $140 million per year.

Fifth, while other industries are hard hit, no industry will suffer as much as ours. We are already the most heavily taxed consumer product in the United States. The federal excise tax alone is already 28½% of the retail price of liquor as compared to 15½% for cigarettes, 5½% for beer and only 1½% for table wine. That is because the alcohol in spirits is taxed at a rate 4 times higher than beer and 16 times higher than wine. Although expenditures on distilled spirits account for only one-third of alcohol beverages sold in the United States, we pay more than one half of total beverage alcohol taxes.

Sixth, the FET is 44% of our gross receipts. It is a tax we collect for the government - a part of our cost of goods sold. If we are barred from deducting it, we are in effect being taxed on gross receipts. That is unfair and discriminatory, and potentially could be unconstitutional.

Finally, while the excise tax deductibility issue has taken center stage in the tax debate, we are equally concerned about the mysterious, and as yet unveiled, proposal to adjust the rates of excise taxes on alcohol, tobacco and motor fuels to "reflect price changes".

We don't know the details of the proposal. And, from what we've heard, it hasn't even been drafted and there is little if any agreement among the committee staff as to how it will operate. It is difficult to testify on a provision which will have a multi-billion dollar impact on many industries but which is simply one line in a spread sheet.

Let me comment anyway on what I'll call the indexing proposal.

It certainly won't simplify the tax code if a different tax is imposed on every different liquor, beer or wine product based on price. Will the tax be imposed on the retail price, the wholesaler price or the manufacturer price? Will one brand of vodka have the same tax as another? Who will police such a provision - the states?, the BATF?, the industry?

It certainly won't help fight inflation. Although total inflation rose 300% between 1951 and 1984, retail prices of liquor have increased less than 80% during that time - only about one fourth of the increase in the overall price level. It is unfair to punish an industry and its consumers with tax increases for maintaining an inflation record far better than the U.S. norm.

Finally, the Canadian experience with indexing taxes is instructive. Between April 1981 and September 1984, the Federal alcohol excise tax in Canada was automatically indexed to changes in the Consumer Price Index for Alcohol Beverages. The indexing policy had the following effects:

1. Federal spirits taxes were raised five times for a total of 53.7%.
2. Retail spirits prices increased almost 50%.
3. Spirits sales fell 19%.
4. 3,200 jobs were lost.
5. Tax rate increases were totally offset by tax collection losses related to reduced consumption, by losses in personal and corporate income taxes and by welfare transfers.

In summary, the net revenue gain to the Canadian government as a result of the indexing policy was zero, while the spirits industry experienced disastrous effects. Because of the unequivocal failure of the policy, the system of indexing was terminated in May 1985!

It makes no financial sense for the federal government to approve a proposal which, in the final analysis could result in less, not more revenues to the federal government. What is the logic and fairness of imposing an indexing proposal on just a few industries? It defies logic to index an already regressive consumer tax.

For all of these reasons, I urge the Committee to reject excise tax proposals which result in huge additional burdens on a few industries and their consumers.

We understand the complexities in competing public interests that arise during the effort to develop major new tax legislation. The Senate Finance Committee has a special obligation to all of the American people and businesses to develop a fair plan that does not single out one group of industries for punitive treatment. We believe the proposal before this Committee heavily penalizes our industry.

The liquor industry is traditionally seen as an easy political hit - a bottomless pit of money. That is not the case. We are a major and a legitimate industry - providing jobs and, indeed, billions of dollars of revenues to the federal and state treasuries. Like all industries, we feel the ebb and flow of economic tides. And for a number of years, we have felt only the ebb. We are at a low point.

We do not ask for special treatment. We pay more than our fair share now. Just 6 months ago, we increased that share. There is a limit to our ability to pay. That limit has already been passed. Enough is enough!

Thank you for your consideration.

April 16, 1986

REGRESSIVE IMPACT OF EXCISE TAXES

Statement
by
Andrew F. Brimmer*

Excise taxes are among the most regressive elements in the nation's tax system. They fall heavily on low- and middle-income families and individuals, and they diminish overall economic welfare. Because of their inherently negative features, any changes that would broaden the scope of excise taxes or increase their rates would make an already bad situation even worse. These are the general conclusions reached in a comprehensive study of excise taxes conducted by Brimmer & Company.

Excise taxes - which are imposed on a wide range of products at the Federal, state, and local level - violate a basic criterion of good tax policy: they do not take account of a taxpayer's ability to pay. Most excise taxes involve fixed rates which are applied to a specific quantity of a commodity sold - such as so many dollars per gallon or cents per pack. Consequently, low- and middle-income consumers have to use a larger fraction of their incomes to pay excise taxes than do citizens with high incomes. The regressive incidence of excise taxes contrasts sharply with that of the progressive individual income tax. In the latter case, the effective tax rate is smallest at the low end of the income scale, and it increases as the level of income rises.

The regressiveness of excise taxes stands out clearly in a comparison of effective rates for different types of taxes. For example, in recent years, excise and sales taxes have accounted for about 9.7% of income among families with annual incomes of $0 - $3,000. Families in the $20,000 - $25,000 bracket used about 4.7% of their income to pay excise and sales taxes. At the $50,000 to $100,000 level, families devoted about 2.6% of their income to this purpose; the fraction was 1.5% in the $100,000 - $500,000 range, and at the very top of the income distribution (those with $1,000,000 and over) the proportion was 1.1%. The most progressive tax - that applying to individual incomes - presented a sharply different picture. In this case, the effective tax rate climbed noticeably with the level of income. Among families with incomes of $0 - $3,000, the effective rate was 2.5%. It was 8.2% at the $20,000 - $25,000 range; 17.6% in the $50,000 - $100,000 range; 19.3% in the $100,000 - $500,000 bracket, and 16.4% for families with incomes of $1,000,000 and over.

Among the various types of excise taxes, those on alcohol beverages may well be the most regressive. This probability is strongly suggested by the data relating to consumer income, expenditures, and taxes in 1982-83 (the latest year for which detailed figures are available), reported by the U.S. Bureau of Labor Statistics (BLS). In that period, families with less than $10,000 of income constituted 28.1% of the total. They had 6.6% of the income before taxes and 7.2% after taxes. These very low-income families were responsible for 13.4% of the total consumer expenditures reported in the BLS survey, and they accounted for 13.5% of the spending for alcohol beverages. Assuming that excise taxes on alcohol beverages are proportional to the quantity purchased, this group would have paid 13.5% of such taxes.. In the same period, they paid only 2.2% of income and related taxes (including Social Security and other payroll taxes).

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*Dr. Brimmer is President of Brimmer & Company, Inc., a Washington, D.C.-based economic and financial consulting firm. He is also a former member of the Board of Governors of the Federal Reserve System.

Families in the $20,000 - $29,999 income range represented 18.9% of all families. They received 20.5% of income before and after taxes, and they made 20.6% of total consumer expenditures. They bought 22.4% of the alcohol beverages, and they paid the same fraction of the related excise taxes - which was slightly more than their 20.3% share of income taxes. Finally, the families with $40,000 and over of income constituted 14.7% of all families. They had 37.5% of total income before taxes and 36.5% after taxes. They accounted for 29.5% of the total consumer spending and for 25.4% of the outlays for alcohol beverages. They also paid 25.4% of the associated excise taxes - substantially less than their 46.3% share of all reported income taxes. Actually, excise taxes paid by upper-income groups are probably less than proportional to their purchases. Thus, their specific share of such taxes is most likely less than indicated here.

In summary, excise taxes are extremely regressive. They impose a much heavier burden on low-income households than on those families with the highest incomes. Moreover, the differential burden on those at the bottom of the income scale has apparently increased over the last two decades.

Given the inherent regressiveness of excise taxes, the adoption of any proposal to raise such taxes would aggravate an already bad situation. This is especially true of the plan being debated in the U.S. Senate Finance Committee. Among other changes, the proposal would (1) make Federal excise taxes and duties on imports no longer deductible for the purpose of calculating income taxes; (2) raise the excise taxes on wine to equal that on beer per unit of alcohol; and (3) index excise taxes on alcohol beverages, tobacco and gasoline to the annual rate of inflation - most probably measured by the consumer price index (CPI). If adopted, the changes would generate about $77 billion of new revenue over five years - divided into $62 billion from excise taxes and $15 billion from tariffs on imports. These estimates would represent an increase of about one-third in Federal government revenue from excise taxes and import duties above the amount it would have otherwise received.

Among the proposed changes, the tying of certain excise taxes to the CPI would be particularly devastating to low- and middle-income consumers. The bulk of the empirical evidence shows that the demand for alcohol beverages, cigarettes, and gasoline is relatively inelastic. This means that the quantity purchased of each of these commodities decreases proportionately less than a given percentage increase in its price. The indexation of excise taxes would lead to progressively higher prices as inflation persisted, but consumption of the affected products would most likely be cut back only moderately. Consequently, low- and middle-income consumers would have to devote a larger fraction of their income to purchase these products. Spending on other types of goods and services would decline, and overall economic welfare would be diminished.

Moreover, tying excise taxes to increases in the CPI would run counter to the policy which Congress adopted in 1981 to prevent income tax bracket creep that otherwise would be produced by inflation. That policy requires individual income tax brackets and tax rate schedules to be adjusted each year to offset the rise in the CPI during the preceding year. Thus, to index excise taxes to increases in the CPI (but not to decreases) would aggravate further the regressive incidence of these taxes compared with the Federal income tax.

If excise taxes were no longer deductible by businesses when they prepare their Federal income tax returns, the results would be severely negative for many small companies and their employees. Under present law, businesses serve as tax collectors; they include excise taxes in the price of the commodity, but the taxes are transmitted promptly to government. Such receipts are not part of the firm's income, and they are excluded when taxes on the latter are calculated. However, in a fundamental break with generally accepted accounting practice, the proposal before the Senate Finance Committee would count excise tax collections as income subject to the highest corporate tax rate. This would be the case even when a company had an actual operating loss. In cases where the firm had an actual profit, the inclusion of excise taxes as taxable income would result in a significant increase in the effective tax rate when actual income is used as the basis for measurement.

Faced with such unwarranted tax increases, businesses would undoubtedly be forced to scale back their operations and lay off employees. These burdensome cutbacks would be particularly heavy for small firms and for workers with few skills who would find it hard to find alternative jobs.

In summary, the existing regressive excise taxes are already distorting spending preferences - especially among low- and middle-income consumers. The net result is a diminution of overall economic welfare. If such taxes were to be increased at the Federal level, the blow would fall most heavily on those with the lowest incomes and the least capacity to absorb it.

4/15/86

DISTILLED SPIRITS COUNCIL

A TAX ON A TAX IS NOT TAX REFORM

The Issue:

In order to make his tax reform package revenue neutral Senator Packwood has proposed denying the deductibility of all federal excise taxes and also has proposed an ad valorem tax on beverage alcohol and other consumer products.

The Problem:

In the case of distilled spirits the manufacturer becomes liable for the tax when the product leaves the manufacturer's warehouse - even before being paid for the goods. The manufacturer charges the wholesaler the price of the product plus the excise tax. The manufacturer then deducts the tax (approximately 44% of the price to the wholesaler) as the cost of goods sold. If the manufacturer is not allowed this deduction it means that he not only pays the excise tax but in effect pays an income tax on the excise tax monies he receives from the wholesaler.

Summary Impact:

- A 54% or a $8.9 billion federal excise tax increase on spirits over five years affecting mostly middle and lower income consumers.

- Loss of 23,000 jobs at all levels of the beverage alcohol industry, including the possible demise of 10,000 small business outlets for spirits.

- Last year's tax hike amounted to a 19% FET increase and a retail price increase of 9%. The nondeductibility provision could result in a 54% FET increase and a retail price increase of an estimated 25% on a typical bottle of spirits.

- Penalizes our industry for being the efficient tax collector for government. In effect, imposes an income tax on our excise tax.

- Causes a drop in state revenues of $140 million per year. States' revenues from liquor sales have increased nearly 500% since 1951. 63 state increases since 1980.

THIS IS NOT TAX REFORM

A Regressive Tax Increase on Middle and Lower Income Families:

1) It is a tax increase - in effect, the equivalent of a 54% increase in the Federal Excise Tax assuming a 35% top corporate tax rate.

2) Last year the federal excise tax on spirits went up 19% - resulting in an estimated 9% increase in the retail package price. The nondeductibility proposal could result in 25% additional increase in the retail price of a typical bottle of liquor. In sum, this proposal on top of last year's tax hike would mean an effective cummulative FET hike of 83% and could mean a retail price increase of over 30%.

It is simply a huge regressive consumption tax that will fall heavily on middle and low income families. Many other basic consumer products - from beer to telephones to tires would likewise go up in price. The increase in taxes on distilled spirits amounts to $8.9 billion over five years, even after taking into account the lowered corporate tax rate.

Not Reform: A Tax on a Tax

The nondeductibility proposal discards a basic tenet of tax policy - i.e., that businesses are charged an income tax only on net income, not on the costs of goods or operations. Excise taxes are deductible because the manufacturer does not pocket any of these dollars. In the case of distilled spirits, whose largest single cost of doing business is excise taxes, taxes would in effect be levied on gross income if the Packwood plan passed. It would be an income tax levied on an excise tax - a tax on a tax.

Penalizing the Tax Collector

The distilled spirits industry makes no money from taxes. It is simply the tax collector. It provides a service for the government and in fact, by paying the taxes up front, is an efficient way for the government to receive its tax monies on a timely basis. The industry pays these taxes even before receiving payment for the goods it sells, thus losing the time/value of the money during the period of time - on average 27 days - between paying the government and receiving payment for goods. Penalizing the tax collector for collecting the taxes is a bizarre catch-22 tax phenomenon.

Small Business Hurt:

Senator Packwood hails his proposal as a boon to small business. To the roughly 275,00 retail establishments selling spirits - liquor stores and taverns - this will come as a surprise. Of them, some 70% are mom-and-pop establishments employing four or fewer people. Preliminary estimates are that the Packwood proposal could:

- cause the typical bottle of spirits at today's price to go up by over 25%
- result in over a 10% drop in demand
- result in about 23,000 lost jobs
- cause the possible demise of 10,000 small business establishments

At the manufacturing level, the industry is already in trouble with capacity utilization down 34% since 1978, plant closings 10% since 1978 and employment down 33% since 1977. Ancillary industries - from glass bottle makers to labellers to farmers who supply grain to barrel makers would hurt.

Threat to the States

Lower demand means lower state revenues. The Packwood plan would result in a loss to the states of $140 million a year. States place significantly more reliance on excise taxes. President Reagan recognized this in his 1981 New Federalism proposal which called for elimination of federal excises on beverage alcohol and returning them to their traditional province - the state level. Larger federal involvement in the excise tax area flies in the face of stated policy of both the Reagan Administration and the National Governors Association.

States have been especially active in the tax area, resulting in about a 500% increase in state liquor tax revenues since 1951. In the last six years, the pace has accelerated, resulting in an additional 63 state tax increases.

Ad Valorem Tax Scheme

The Packwood proposal to tie excise taxes on beverage alcohol and other consumer products to some form of inflation adjustment unnecessarily complicates the tax code while at the same time ignoring the fact that excise taxes are the traditional province of the states. Since 1951, state revenues have increased by almost 500%.

It is unwarranted and unfair to base alcohol taxes on inflation increases. Although total inflation may have risen 300% over the last 30 years, retail prices of whiskey have increased only 73%; and distilled spirits producer prices (net of FET) have gone up only 84% between 1953-83. It is fundamentally unfair to punish an industry and its consumers with tax increases simply for maintaining an inflation/productivity record far better than the U.S. norm.

For further information, contact Jeff Peterson on 682-8880.

NON-DEDUCTIBILITY IMPACT FROM LIQUOR ON FINANCE COMMITTEE STATES

Finance Committee State	Jobs lost	Businesses lost	% Change *
Colorado	460	200	-5.42
Delaware	70	30	-13.55
Kansas	130	100	-4.42
Louisiana	500	350	-27.19
Minnesota	550	120	-32.24
Missouri	340	290	-15.17
New Jersey	1100	400	-5.08
New York	1600	970	-17.63
Oklahoma	130	30	-17.00
Rhode Island	100	60	-7.64
Texas	1100	440	-4.28
Hawaii	230	70	-29.16
Idaho	85	30	-19.7
Iowa	240	160	-14.23
Maine	115	50	-11.91
Montana	120	60	-11.46
Oregon	290	70	-8.39
Pennsylvania	920	680	-4.34
Wyoming	70	70	-7.37

*Consumption change in 3 month period following Oct. 1, 1985 FET increase.

Total Revenue Lost: $38,190,000

Total Jobs Lost: 8,150

Total Businesses Lost: 4,180

FINANCE COMMITTEE STATES
ADULT PER CAPITA CHANGE IN CONSUMPTION
OF
SPIRITS, WINE AND BEER
1975-1984

MISSOURI		MINNESOTA	
Spirits	-26.3%	Spirits	-12.4%
Wine	36.4%	Wine	43.7%
Beer	6.0%	Beer	- 2.5%
TEXAS		ARKANSAS	
Spirits	1.6%	Spirits	3.5%
Wine	51.5%	Wine	6.3%
Beer	8.8%	Beer	13.0%
NEW YORK		COLORADO	
Spirits	-17.7%	Spirits	-19.4%
Wine	19.4%	Wine	16.1%
Beer	- 4.0%	Beer	- 2.1%
OKLAHOMA		Delaware	
Spirits	-11.3%	Spirits	-12.2%
Wine	15.8%	Wine	60.8%
Beer	2.6%	Beer	14.8%
PENNSYLVANIA		HAWAII	
Spirits	-16.8%	Spirits	-28.8%
Wine	6.3%	Wine	17.2%
Beer	- 0.2%	Beer	6.4%
RHODE ISLAND		IDAHO	
Spirits	-17.1%	Spirits	-11.9%
Wine	25.2%	Wine	28.8%
Beer	- 5.3%	Beer	- 9.7%
NEW JERSEY		IOWA	
Spirits	- 9.3%	Spirits	-21.7%
Wine	40.1%	Wine	33.5%
Beer	- 1.0%	Beer	1.2%
OREGON		KANSAS	
Spirits	-13.3%	Spirits	-12.1%
Wine	7.8%	Wine	35.9%
Beer	- 3.4%	Beer	- 8.0%
WYOMING		LOUISIANA	
Spirits	-21.9%	Spirits	- 6.6%
Wine	10.3%	Wine	1.5%
Beer	-18.6%	Beer	4.9%
MAINE		MONTANA	
Spirits	- 1.0%	Spirits	-18.9%
Wine	42.5%	Wine	79.9%
Beer	-16.3%	Beer	- 5.2%

CONCLUSION

DURING 1975-84, 18 OUT OF THE 20 FINANCE COMMITTEE STATES EXPERIENCED A DECLINE IN ADULT PER CAPITA CONSUMPTION OF DISTILLED SPIRITS RANGING FROM 1% to 29%. BEER CONSUMPTION INCREASED IN 8 OUT OF THE 20 STATES, AND WINE CONSUMPTION INCREASED IN ALL 20 STATES.

Consumers and Consumption Ratios
For Liquor, Beer and Wine

- 1985 Simmons Market Research data reaffirm the essential similarity of income-distribution patterns for spirits, beer and wine. About two-thirds of all beer, spirits and wine drinkers are members of the upper-income brackets.

1985 Income Group	% of Beer Drinkers	% of Spirits Drinkers	% of Wine Drinkers
Under $20,000	36%	33%	30%
$20,000 and over	64	67	70

- There is no evidence of a significantly greater concentration of beer consumption among lower income groups.

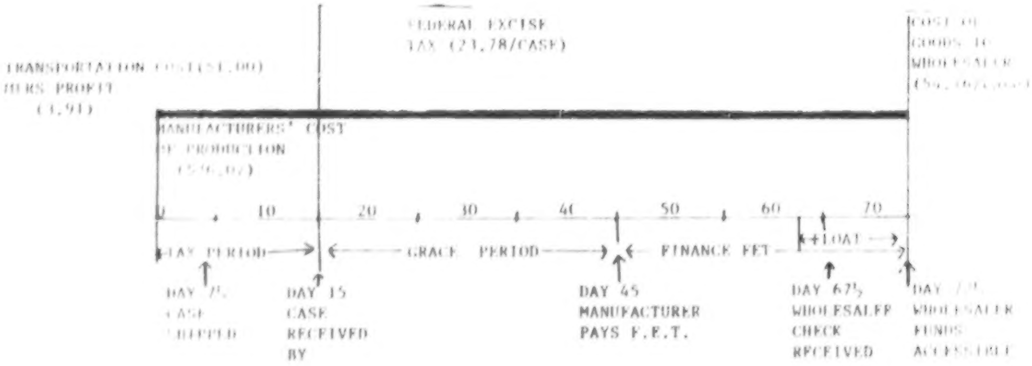
1985 Income Group	% Beer Consumption	% Spirits Consumption	% Wine Consumption
Under $20,000	40%	33%	28%
$20,000 and over	60	67	72

- Furthermore, beer clearly is targeting growth in upper-income brackets. Over half the beer sold in the U.S. during 1984 was premium priced or higher; less than one-fourth was popular priced. Light and imported beers were the fastest-growing segments of the beer market in 1980-84. Premium beers had bv far the largest share of the market (45%), followed distantly by popular-priced beers (23%) and light beers (20%).

CONCLUSION:

CONSUMER SURVEYS CONFIRM IT IS A MYTH. BEER IS NOT 'THE WORKING MAN'S DRINK.' LIQUOR IS NOT 'THE DRINK OF THE RICH.'

SAMPLE CASE OF DISTILLED SPIRITS
COST COMPONENTS AND IMPORTANT DATES


FEDERAL EXCISE
TAX (23.78/CASE)
TRANSPORTATION COST($1.00)
HERS PROFIT
(1.91)
MANUFACTURERS' COST
OF PRODUCTION
COST OF
GOODS TO
WHOLESALER
0
10
20
30
40
50
60
70
PAY PERIOD
GRACE PERIOD
FINANCE FET
FLOAT
DAY 7½
CASE
SHIPPED
DAY 15
CASE
RECEIVED
BY
DAY 45
MANUFACTURER
PAYS F.E.T.
DAY 67½
WHOLESALER
CHECK
RECEIVED
DAY 72
WHOLESALER
FUNDS
ACCESSIBLE

- Manufacturers are Excise Tax Collectors for the Federal government.

- Manufacturers must pay Treasury the Federal tax on Day #45, 27 days prior to collecting it from the wholesalers on Day #72.

- Because the FET is paid by the manufacturer before it is collected, the manufacturer derives no benefit. The collection is not used - it is not pocketed. It is reimbursement to the manufacturer for a payment already made to the Treasury.

- The nondeductibility proposal is therefore a tax on a tax already paid to the Treasury.

FACT SHEET

International Examples of Excise Tax Increases on Distilled Spirits

Recent experiences in other countries have demonstrated that punitive levels of spirits taxation can lead to major decreases in consumption. Such decreases adversely affect public revenues which depend on steady or climbing consumption, and inflict significant economic hardship on those whose livelihood depends on the sale and distribution of distilled spirits.

Australia: In August 1978, Federal taxes on spirits were increased 82%. This led to a 40% price increase and a 26% overall decline in spirits sales. The Australian Treasury had projected a two-year revenue gain of $260 million. Actual collections were less than half that amount. Between 1978 and 1983, per capita spirits consumption declined 2.3% annually. Because of changes in the 1983-84 Budget, spirits taxes are now indexed to changes in the Consumer Price Index. As a result, taxes were increased 4.3% in 1983-84, causing an 8.3% decline in per capita consumption.

Canada: Between April 1981 and September 1984, the Federal alcohol excise levy was automatically indexed to changes in the Consumer Price Index. As a result, Federal spirits taxes were raised five times for a total 53.7%. Retail spirits prices climbed almost 50%, spirits sales fell 19%, and 3,200 jobs were lost during this period. Excise tax rate increases were totally offset by excise losses resulting from reduced consumption, by losses in corporate and personal income taxes, and by welfare transfers. Because of its disastrous impact on the alcohol industry, this system of indexing was terminated in May 1985.

Denmark: As a result of reduced demand because of a 37.5% tax increase in August 1977, Federal tax revenues from spirits actually declined by 12% the following year. Per capita spirits consumption in 1983 remained below 1976 levels.

Germany: Excise tax increases of 15.4% and 13.3% in 1981 and 1982, respectively, caused a 14.5% drop in spirits sales in 1982. Tax revenues were so much below what had been expected that the German government shelved plans for a 1983 tax increase. In 1983, the number of spirits producers declined 7.3%; and employment fell 7.5%. Sales were down again in 1984, and per capita spirits consumption declined 16.3% between 1980-84.

Ireland: Successive excise and value added tax increases totaling 126% were placed on spirits between 1978-1982. Following the last tax increase of 8.5% in 1982, sales immediately dropped 17%. In 1984, spirits demand was 24% below 1981 levels, while government revenue from excise taxes had declined by 20.8%. Faced with steadily declining sales, consumption and tax revenues, the Irish government reduced the excise tax on spirits by 20% effective October 1984.

Japan:	On May 1, 1984 excise taxes on alcohol beverages were increased; on average by 24% for distilled spirits at 74 proof or greater. The higher tax raised prices of whisky and brandy typically by 9% and, over the following year, decreased spirits consumption (74° or greater) by 10.1%. Because of falling sales, fiscal year 1984 (April 1984-March 1985) spirits tax revenues were 19% below the Japanese government's projections. Taxes are now about 43% of retail price on a bottle of whisky at 80 proof.
United Kingdom:	Following tax increases in 1980 and 1981, the U.K. Treasury forecast a 10% increase in revenues from spirits. Actual gains were a marginal 0.6% increase, one-seventeenth of expected additional revenue.

Distilled Spirits Council of the U.S., December 11, 1985

U.S. ECONOMIC FACT SHEET: THE DISTILLED SPIRITS INDUSTRY

- Taxes on distilled spirits account for roughly 49 percent of the typical retail bottle price of spirits.

- As a result of the 1st October 1985 increase in the Federal Excise Tax (FET) on liquor, from $10.50/proof gallon to $12.50/proof gallon, Federal taxes alone account for 29 percent of the retail price. The FET on beer and wine was not increased.

- While expenditures on liquor account for only 34% of the pure alcohol beverage sold in the U.S., due to its higher tax rate compared to beer and wine it accounts for 56% ($6.9 billion) of total public revenues from alcohol beverages ($12.5 billion).

- The alcohol beverage industry contributes $5.6 billion to the Federal treasury, $3.7 billion (over 65 percent) from liquor. Only taxes on gasoline and crude oil generate more Federal excise revenue than do alcohol beverage taxes.

- The alcohol beverage industry contributes $6.5 billion to state and local governments, equal to over 70% of all state expenditures on health, or well over twice state expenditures on police protection.

- There are over 400,000 alcohol beverage manufacturers, wholesalers and retailers in the U.S. employing 784,000 people directly (full-time equivalent). Additionally, for every ten persons employed in alcohol beverage manufacturing, there are 37 persons employed indirectly in supplier sectors, or about 250,000 people.

- There are roughly 275,000 retail establishments which sell distilled spirits. Nationwide, 60%-70% of retail liquor stores and on-premise "drinking places" are Mom-and-Pop establishments, those employing four or fewer people.

- Industry contributions to the U.S. economy in 1983 included $18.9 billion in payrolls and profits. Retail in 1984 sales were $66.4 billion, $22.5 billion of liquor.

- The Federal government has granted licenses for 7,875 small fuel-alcohol plants in the U.S., each capable of producing up to 10,000 proof gallons annually. The potential exists that the alcohol might be diverted to produce illegal, non-taxed liquor.

CONTRIBUTION OF ALCOHOL BEVERAGES TO PUBLIC REVENUES

Year	Federal Tax Collections ($millions)		State & Local (Excise and Other Tax) Collections ($millions)		Total Tax Collections ($millions)	
	Distilled Spirits	Alcohol Beverages	Distilled Spirits	Alcohol Beverages	Distilled Spirits	Alcohol Beverages
1980	3,886	5,701	2,894	5,616	6,780	11,317
1981	3,933	5,845	3,018	5,975	6,951	11,820
1982	3,687	5,572	3,079	6,247	6,766	11,820
1983	3,757	5,652	3,174	6,553	6,931	12,205
1984	3,639	5,580	3,296	6,897	6,935	12,477

	CONTRIBUTIONS TO THE NATIONAL ECONOMY - ALL ALCOHOL BEVERAGES				LIQUOR CONSUMPTION	
Year	Licenses Issued*	Employment**	Payrolls** & Profits ($mil)	Retail Sales ($mil)	Total (000 gal.)	Per Capita (gal.)
1977	389,360	814,840	11,441	39,658	431,553	1.96
1981	427,489	826,900	18,222	56,670	449,453	1.96
1982	421,682	803,260	18,748	58,623	437,659	1.89
1983	420,642	784,200	18,918	63,680	431,132	1.84
1984	--	--	--	66,355	426,157	1.80

* Approximate number of manufacturing, wholesale and retail establishments.
* Includes full-time equivalent employees and payroll at retail.

Sources: Estimated from data of Bureaus of Census; Alcohol, Tobacco and Firearms; Labor Statistics; Economic Analysis; also Internal Revenue Service, Distilled Spirits Council of the U.S., Wine Institute and U.S. Brewers Association, and tax authorities of the several states and District of Columbia.

Distilled Spirits Council of the U.S., April 11, 1986.

Distilled Spirits

Industry Employment and Capacity Utilization Losses

Total Industry Employment

- 1977 - 1982, 24% decline (Department of Commerce)
- 1982 - 1984, 8.6% decline (DISCUS survey)

Employment of Production Workers

- 1977 - 1982, 27.5% decline (Department of Commerce)
- 1982 - 1984, 15.3% decline (DISCUS survey)

Capacity Utilization

- Capacity dropped from 100% in 1978 to 66% in 1984.
- Capacity utilization would have been significantly lower had not 10% spirits plants closed since 1978.

Plant Closings and Shutdowns

- 1982 and 1983, 6 plants closed; net employment loss of 760 workers
- 1984, 3 additional plants closed; loss of 350 workers
- Additionally, from 1983 - 1985, employees in some spirits plants were unable to work full employment years due to temporary shutdowns.

NON-DEDUCTIBILITY IMPACT FROM LIQUOR ON FINANCE COMMITTEE STATES

Finance Committee State	Jobs lost	Businesses lost	% Change *
Colorado	460	200	-5.42
Delaware	70	30	-13.55
Kansas	130	100	-4.42
Louisiana	500	350	-27.19
Minnesota	550	120	-32.24
Missouri	340	290	-15.17
New Jersey	1100	400	-5.08
New York	1600	970	-17.63
Oklahoma	130	30	-17.00
Rhode Island	100	60	-7.64
Texas	1100	440	-4.28
Hawaii	230	70	-29.16
Idaho	85	30	-19.7
Iowa	240	160	-14.23
Maine	115	50	-11.91
Montana	120	60	-11.46
Oregon	290	70	-8.39
Pennsylvania	920	680	-4.34
Wyoming	70	30	-7.37

*Consumption change in 3 month period following Oct. 1, 1985 FET increase.

Total Revenue Lost:	$38,190,000
Total Jobs Lost:	8,150
Total Businesses Lost:	4,180

STATEMENT OF AUGUST A. BUSCH III, CHAIRMAN OF THE BOARD AND PRESIDENT, ANHEUSER-BUSCH COS., INC., ST. LOUIS, MO, ON BEHALF OF THE BEER INSTITUTE

Mr. BUSCH. Good morning, Mr. Chairman, and thank you for holding these hearings.

My name is August Busch, and I am chairman and chief executive of Anheuser-Busch Cos. Our testimony, some 25 pages of it, has been presented for the record. I will, sir, in less than 5 minutes give you a summary of our position.

The following nine points are emphasized in the testimony of the Beer Institute, representing all brewers.

Regarding the excise tax provisions of the tax proposal currently before your committee, they are:

Eliminating the deductibility of the Federal excise tax would disallow a normal business expense that is recognized throughout the world and increase Federal excise taxes by 54 percent.

It would, in essence, mean that a corporation which collects money for the Federal Government and does not keep $1 in corporate revenue would pay a tax on a tax.

Excise taxes should not be increased in the name of tax reform. Their impact on consumers is highly regressive, and their impact on businesses is highly arbitrary.

Moreover, they are hidden in the purchase price of taxed products and are not readily subject to review by the electorate.

Eighty million working Americans drink beer for social enjoyment and relaxation. Their taxes should not be increased.

Senator SYMMS. How many did you say, Mr. Busch?

Mr. BUSCH. Eighty million Americans, Senator.

Some people claim that a sales decline would result and therefore help combat alcohol abuse. But it is simplistic to assume that abusers will be discouraged by price. In reality, it will be the average working man and woman who are responsible beer drinkers who will be forced to reduce the amount that they purchase because of higher prices, sir.

The beer excise tax provisions would generate $1.2 billion for the Treasury annually; but, since the cost will be built into the price of beer at the brewery, it would be marked up by wholesalers and retailers and ultimately cost the consumers $2.5 to $3 billion annually, or more than twice as much as the Government would realize through the measure. Such a price increase—80 cents to $1 per case—to the consumer would be expected to reduce industry sales by 3 percent, or the equivalent of the entire sale of beer in the entire State of New Jersey.

Higher excise taxes would be highly detrimental to the brewing industry and, through it, to the economy in general.

Brewing is an overwhelmingly American industry and provides jobs for 190,000 U.S. workers and farmers.

Beer sales have been flat to down for the past several years. Higher prices would inevitably reduce sales and cost thousands of jobs.

This provision would create an effective corporate income tax rate on industries required to act as tax collectors, far in excess of the maximum 35 percent rate suggested in the draft bill.

At Anheuser-Busch it would mean an approximate 60 percent corporate tax rate.

Indexing beer excise taxes to price increases would magnify the problems over time.

And finally, Senator, by raising the excise rate on wine to a level comparable to that of beer, the draft bill appears to endorse the mistaken notion that beverages should be taxed on the basis of alcohol content. Beer, wine, and liquor are different products with different physical and social characteristics, and different consumers. Their contributions to our Nation's economy vary widely.

Proven long term Federal and State policies that recognize these differences and have done so for more than 200 years should not be discarded in the name of tax reform.

The draft bill sets a bad precedent, would disrupt several major U.S. industries, and does not qualify as tax reform. We think it should be rejected.

Again, I want to thank you, Mr. Chairman, for the opportunity to appear here today.

The **Chairman**. Thank you.

Mr. Debevc.

[Mr. Busch's written prepared testimony follows:]

TESTIMONY SUBMITTED BY

AUGUST A. BUSCH III

CHAIRMAN OF THE BOARD AND PRESIDENT

ANHEUSER-BUSCH COMPANIES

ON BEHALF OF

THE BEER INSTITUTE*

TO THE UNITED STATES SENATE

FINANCE COMMITTEE

APRIL 21, 1986

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*The Beer Institute represents 32 United States brewers and 62 associate members. A list of members is appended to this testimony.

INTRODUCTION

The tax proposal prepared by the U.S. Senate Finance Committee staff (Staff Option) raises several issues of vital concern to the Brewing Industry. If enacted, the plan now before the Committee would restructure the brewing industry in basic and damaging ways, and penalize the more than 80 million Americans who consume its products. Specifically:

- Elements of the plan which would eliminate the ability of brewers and others who collect excise taxes for the federal government to deduct those funds from their taxable income, and similar treatment of tariff collections, constitute a hidden, discriminatory, regressive and inefficient form of tax increase.

- Indexing federal excise tax rates for beer and other alcohol beverages, tobacco and gasoline would simply magnify the negative effects of the tax reform proposal over time, continually increasing a tax burden that falls disproportionately on America's working men and women -- low- and middle-income families who are already paying their fair share of taxes.

- By raising the excise tax rate on wine to a level comparable to that of beer, the proposal appears to endorse the mistaken notion that beverages should be taxed on the basis of their alcohol content, rather than on how and when they are consumed, and by whom.

Tax reform may be a worthwhile goal. In fact, many members of our industry have voiced support for the House tax reform bill, which spreads the tax burden throughout all of corporate America rather than focusing on one group of industries.

But due to the concerns cited above, the Staff Option under consideration cannot be considered a reform measure. It would set damaging precedents and dislocate proven federal tax policy. This proposal increases regressive, hidden and inefficient taxes in order to decrease the government's reliance on more progressive tax provisions. As such, it is basically and essentially flawed.

THE PROPOSAL DOES NOT CLOSE TAX LOOPHOLES ...
IT RAISES FEDERAL EXCISE TAX RATES

Proponents of the Staff Option claim that it qualifies as a reform measure, in part because it closes an alleged "tax loophole" by eliminating the deductibility of federal excise taxes. In fact, excise taxes are recognized throughout the world as a legitimate business expense. By disallowing their deductibility, the Staff Option would effectively raise all federal excise taxes by 54 percent.

- o Under current tax law, a business whose products are subject to excise taxes can maintain its after-tax position by increasing the price of its product by the amount of the tax. That is because the business collects the tax, pays 100% of it to the Treasury, and then deducts these payments from its taxable income.

- But under the proposed Staff Option, all excise taxes collected by a business would be subjected to a 35% corporate tax rate, since the funds passed on to the federal government could no longer be deducted. To maintain its after-tax position, a business would be forced to increase its prices by 54 cents for each $1 in excise taxes.

By treating excise tax collections as if they are real income for producers, rather than taxes which the federal government requires producers to collect, the Staff Option indulges in a damaging and unfair fallacy which creates an astonishing tax precedent. For if excise taxes -- over which producers have no control -- are disallowed as a cost for income tax purposes, the deductibility of all other legitimate business expenses is then at risk.

Brewing industry practices dramatically illustrate the economic fallacies of the Staff Option proposal. Brewers collect a $9 per barrel federal excise tax from their wholesalers when the product is invoiced and leaves the brewery premises. That amount is paid every two weeks, via electronic funds transfer, by the brewer to the Treasury.

Thus, the brewer functions solely as a collecting agent for the government. In fact, brewers must employ people to manage the tax accounting and payments, and are subject to harsh penalties if any errors occur.

By eliminating the excise tax deduction, this proposal -- described as "closing a loophole" -- in reality levies a tax on a tax and penalizes those businesses singled out to provide a tax collection service for the government. It would establish income tax rates on the effected industries far in excess of the 35% maximum that would purportedly result from this plan. For example, the Beer Institute estimates that if the Staff Option were imposed, the effective corporate income tax rate on the nation's five largest brewers would be approximately 65 percent.

EXCISE TAXES -- AN UNSOUND WAY TO GENERATE REVENUE

Claims that the Staff Option constitutes tax reform are particularly ironic when the proposal is seen for what it truly is -- an excise tax increase, not a loophole closer. Indeed, few methods of generating revenue are more regressive, more discriminatory, or less accountable to voters.

That is why excise taxes have been criticized by experts from across the political spectrum. For example, the Institute for Research on the Economics of Taxation found that:

> "Selective excises should not be employed merely to raise revenue. These taxes are distortionary and, given the current emphasis on broad-based, comprehensive neutral tax systems, the use of excises purely for revenue purposes would be a giant step backwards." (Institute for Research on the Economics of Taxation, Economic Report #7, Oct. 29, 1981).

Similarly, Citizens for Tax Justice, a labor-supported public advocacy group, attacked the proposal under current consideration as "nothing but a huge consumption tax that will fall heavily on middle- and low-income families," (New York Times, March 17, 1986). Harvey Galper, a tax economist with the Brookings Institution, commented on the pending proposal: "I really think there is a truth-in-packaging problem here." (The Washington Post, March 19, 1986).

Excise taxes have several major flaws that make them very undesirable as a means of generating revenue.

> **Excise taxes are based on consumption patterns, not on the taxpayer's ability to pay. As such, they are highly regressive.**

It is false to think that excise taxes are levied on individual industries, or even on specific products. They are levied on the people who consume those products. The inequities of excise taxation are emphasized by focusing on who is being taxed, rather than what is taxed.

In the case of beer, the U.S. Department of Labor Statistics (Bureau of Labor Statistics, Consumer Expenditure Survey, 1980-81) reports that households with incomes in the $20,000 to $25,000 range spend more than 50% of their alcohol beverage budget on beer. Conversely, those with family incomes of more than $50,000 spend only about 25% of their alcohol beverage budgets on beer. Two-thirds of all beer consumed in the U.S. is purchased by families with incomes of $30,000 or less.

Since beer is most popular among American working men and women, tax policies that raise the price of beer are highly regressive and place an unfair burden on people who are already paying their fair share. In fact, raising the excise taxes on beer is one of the single most regressive aspects of the Staff Option.

Excise taxes in general fall disproportionately on low- to moderate-income families. Therefore, increased reliance on excise taxes would severely erode the tax benefits intended for such groups as proposed by the Staff Option. This would ultimately make our tax code more regressive, rather than less. For example, a recent study reports that:

> "For individual taxpayers in the aggregate, the excise tax and tariff provisions would wipe out almost half of the income tax reduction promised by this plan. The effect by income class would be very uneven. Those in the highest bracket would lose in this way only 6 percent of their income tax reduction whereas those in the lowest bracket would lose more than 60 percent of theirs." (deSeve Economics, April, 1986).

The overall impact of the proposal would be to give the biggest tax breaks to the people who already have the most. That hardly qualifies as tax reform.

Excise taxes disrupt the workings of the free marketplace, imposing a penalty on the producers, distributors and consumers of one class of products relative to the rest of the economy.

As reported in a recent assessment of the proposal currently before the Finance Committee:

> "If one may appropriately assume that free markets provide price and cost information that leads to the most effective use of production capability and a composition of output that best and most economically satisfies our demands, then the price-and-cost-distorting effects of selective excises must result in a *less than effective use of our production capability and a less satisfying market basket of goods and services*." (Institute for Research on the Economics of Taxation, Economic Policy Bulletin 22, March 24, 1986. Emphasis added).

Based in part upon its excise tax provisions, the Staff Option has been highly criticized for its potentially disruptive impact on the nation's economy. For example, the Center for the Study of American Business found that the plan would:

> "... retard investment, slow economic growth and raise unemployment. If the Federal Reserve made no attempt to cushion the economy from the effects of the proposal, real GNP in 1991 would be 2.1% lower than under current law, and the civilian unemployment rate would be 1.3 percentage points higher." (Prakken, et al, March, 1986).

Excise taxes reflect the Congress's idea of how the market should work -- not how it would work if left unhindered by artificial restraints.

To fully appreciate the extremely arbitrary nature of excise taxes, it should be remembered that since 1951 federal excise taxes have been removed from such items as furs, jewelry, perfume, silver bullion and slot machines. But they remain on such products as beer, gasoline, tires, hunting and fishing equipment, long distance telephone service and airline tickets. Indeed, one must wonder why excise taxes are sometimes described as "luxury" taxes.

The brewing industry offers a telling example of the distortionary effects of excise taxes. Every time one of America's 80 million beer drinkers buys a six-pack, he or she pays about three times more tax than when purchasing other goods which have no excise taxes. Beer drinkers already pay

$1.6 billion each year in federal excise taxes, plus $1 billion annually in state excise taxes and license fees, plus another $1.5 billion in state and local sales taxes. The average price of a six-pack of beer includes more for taxes than for agricultural raw materials and labor -- combined.

Certainly, increased reliance on a tax that arbitrarily gives some industries an advantage over others does not constitute tax reform.

> **Excise taxes are "hidden" from the view of taxpayers in the price of products they purchase every day.**

Chief Justice John Marshall once commented that "... the power to tax involves the power to destroy." That is why it is universally agreed that hidden taxes are bad taxes. Taxpayers cannot hold their legislators accountable if they are unable to readily determine how much money the government is taking out of their pocket, and then assess if that level is justified.

But, by decreasing reliance on personal income taxes (which are fully visible to the taxpayer) in favor of excise taxes, this proposal makes government less, rather than more, accountable. Taxpayer concerns about government waste and accountability should not be blindsided by such a hidden tax increase in the name of reform.

For these three reasons -- the regressiveness of excise taxes, their disruptive impact on the marketplace, and the fact that they are concealed from taxpayers -- excise taxes should not be increased in the name of tax reform ... or for any other reason. In fact, true tax reform should reduce government reliance on excises in favor of broader-based and more equitable means of raising revenue.

BREWING INDUSTRY IMPACT OF THIS TAX PROPOSAL

To fully understand the potential impact of the current tax reform proposal on the brewing industry -- and through it, on the U.S. economy as a whole -- several factors must be taken into account:

- Brewing is an overwhelmingly American industry, with approximately 95% of all the beer consumed in this country produced by U.S. brewers. The industry's contribution to the U.S. economy is substantial, including almost $5.5 billion in annual expenditures for packaging and agricultural products alone.

- More than 43,000 Americans work in breweries, another 87,000 work for beer wholesalers, and hundreds of thousands of persons derive their income in whole or in part from the more than 500,000 licensed retail outlets that sell beer. Additionally, almost 19,000 American farmers derive their income from supplying the brewing industry with raw materials, and more than 34,000 persons work for companies that provide the industry with necessary supplies of cans and bottles.

In all, almost 190,000 Americans gain their livelihood directly from the brewing industry -- not counting retail employees. (Weinberg & Associates, 1985).

- Brewing industry sales have been flat to down for the past five years. In 1985, total sales increased by two-tenths of one percent -- but sales by domestic brewers declined by 400,000 barrels. Per capita consumption is slowly declining. More than 30 American breweries have closed since 1977, and the industry has lost more than 4,000 jobs. The Staff Option would terribly disrupt an industry that is already facing economic hard times.

- Beer consumers are overwhelmingly working men and women, with two-thirds of American beer sales accounted for by families with annual incomes of $30,000 or less. This segment of the population has benefited from many federal programs that are now being reduced or eliminated. They have benefited the least from tax measures adopted over the past several years. They should not be asked to bear an additional and discriminatory tax burden.

Given all of these factors, it can be seen that the proposal under consideration by the Finance Committee would have a wide-ranging ... and damaging ... impact on a major American industry. For inevitably the measure would cause higher prices, reduced sales and increased unemployment.

THE IMPACT OF THE PROPOSAL ON THE PRICE OF BEER

Beer excise taxes are one of the most inefficient methods of generating government revenue ever devised.

The Beer Institute estimates that the tax proposal under consideration would increase federal revenue derived from the sale of beer by approximately $1.2 billion a year. For the following reasons, America's beer consumers would end up not only paying that amount ... but much more.

- By eliminating the deductibility of excise taxes collected by brewers for the federal government, the taxable income of all brewers would immediately increase by about $1.6 billion. The Beer Institute estimates that this would increase the taxable income of the nation's brewers by an amount that is two to three times more than their current net profits.
- Even at a 35% tax rate, such a large increase would completely eliminate the profitability of most brewers, and shrink the profits of the few remaining producers almost to the vanishing point. To remain whole, every brewer would have to raise prices.

While the tax reform proposal as applied to the brewing industry would generate approximately $1.2 billion in additional revenue, its impact on consumers would be more than twice that amount. That is because the tax is levied at the brewer level, and becomes subject to normal business markups at the wholesaler and retailer links of the distribution chain.

Brewing is an intensely competitive industry. The mechanics of the marketplace strongly encourage brewers, wholesalers and retailers to keep prices as low as possible. Indeed, the consumer price of beer has consistently increased less than the Consumer Price Index.

Historically, brewers have simply folded the cost of any excise tax increases into their existing price structure on a dollar-for-dollar basis, without additional markup. Markups have not been necessary since -- thanks to the deductibility provisions of the tax code -- excise taxes are simply a financial "pass-through" for brewers.

However, since the excise tax is an intrinsic part of the wholesaler's basic cost structure, it will be marked up if market conditions permit. But if the law of supply and demand forces the wholesaler to simply pass through the tax increase, he will incur additional inventory costs and sales losses, without recouping those expenses.

Similarly, retailers base their markup on the total cost of the products they buy, of which the federal excise tax is a part. From the retailers' perspective, when an excise tax goes up, all they see is a price increase. To maintain their profitability, they will mark up their increased costs if market conditions allow.

Thus, by the time the tax reaches the consumer, it has usually been marked up twice -- and it is more than twice as large as it was at the brewer level. As a result, the total consumer cost of this tax proposal would not be $1.2 billion -- but $2.5 to $3 billion per year.

THE PROPOSAL'S IMPACT ON BEER SALES AND INDUSTRY EMPLOYMENT

Economists have long studied how sales of various products -- including beer -- respond to price increases. Using commonly accepted approaches, the price increases necessitated by the current proposal are expected to decrease brewing industry sales by about 3% during the first year. This is a non-recoverable loss that would eliminate from 75 to 80 million cases from the industry's total volume. This amount exceeds the industry's total annual sales in New Jersey (its 9th largest market) ... and is three times the total annual beer sales for the entire state of Oregon.

Some have argued that by driving down consumption, higher excise taxes would help solve the problem of alcohol abuse. This is a gross oversimplification. Manipulating the tax code to increase the price of alcohol beverages will penalize the responsible drinker but leave the abusive drinker's behavior unchanged. Higher taxes may cause abusive drinkers to switch to cheaper products, but will not solve abuse. As noted in a study published by the National Institute on Alcohol Abuse and Alcoholism,

> "... attempts to reduce overall consumption by limiting availability via a tax or price policy *could well be least effective with precisely those who are abusing alcohol.*" (Jessor & Jessor, 1980. Authors' emphasis).

Thus, the higher excise taxes proposed in the Staff Option will not reduce abusive drinking. But these tax increases will cause decreases in consumption among responsible drinkers for whom the tax hike causes budget problems. Two additional factors will magnify this effect:

o First, the consumer price of beer includes substantial costs for transporting raw materials to the brewery and for shipping bulky finished goods through the distribution chain. The Staff Option will raise transportation costs by raising the price of truck fuels, tires, parts and fees. Thus, the measure will create significant "ripple" effects and further increase the price of beer (and many other goods).

- Second, since excise taxes fall disproportionately on middle- and low-income consumers -- who comprise a very large portion of the beer drinking public -- the purchasing patterns of this group could be changed in drastic and unanticipated ways. For example, if a consumer earns $30,000 a year, uses a light truck for work, likes to hunt and fish, and drinks one six-pack of beer each weekend ... how will the cumulative impact of this tax package affect his overall buying habits? This cannot be estimated with precision, but there is little doubt that the disruption to the marketplace would be substantial.

Brewing industry jobs would be lost to the tax proposal under consideration ... and the following factors indicate that the number is unacceptably high:

- Overall industry employment has been declining slowly for the past several years.

- In recent years, major breweries have been closed in Wisconsin, Michigan and Ohio ... and in 1985, industry plant utilization rates stood at 85 percent.

- Total industry sales are expected to grow only slightly over the next several years -- if federal excise taxes are not raised. The substantial price increase that would result from the Staff Option, plus the plan's indexing proposal, would more than eliminate these gains.

Thus, after several years in which sales have been flat to down, additional volume declines would lead immediately and inevitably to lost jobs -- almost 6,000 jobs, if employment dropped by the same percentage as industry sales. These victims of "tax reform" would certainly have every reason to hold Congress responsible.

While the large brewers might well be forced to reduce employment, the situation is much worse for small brewers. Since their operating profits are already among the lowest in the industry, and significant productivity improvement would be unacceptably expensive, many would find it difficult to survive. "Tax reform" may close the doors of many small brewers. And closed breweries, and unemployed workers, pay no taxes and are a drain on government.

INDEXING BEER EXCISE TAXES:
INSTITUTIONALIZING HIGHER PRICES

Levying taxes is one of the most important and far-reaching responsibilities of government -- and one that should not be put on "automatic pilot."

But the proposal under consideration would do precisely that, indexing the excise tax rate for beer, wine, spirits, gasoline and tobacco to price increases. Whenever prices go up on these products, taxes on their consumers will increase as well. This would not only sustain the negative effects of higher excise taxes discussed earlier in this testimony -- it would actually increase them over time.

Under a straightforward indexing scheme, the excise tax on beer drinkers would be 63% higher in 1996 than it is today if the tax rate grew 5% annually over the next decade. But thanks to the non-deductibility provisions of the tax proposal, the actual increase would be much higher.

It is instructive to note that Canada imposed an indexed excise tax system on its brewing industry in 1980, and abandoned the arrangement five years later. During the five years preceding indexed excise taxes, beer prices had been tracking below the CPI. During the five years of indexing this relationship was reversed. And, the Canadian situation during indexing would have been much worse had the deductibility of their excise taxes been disallowed.

In addition to disruption of the affected industries, indexing is simply bad public policy. Consider that:

o Indexing relieves Congress of the necessity of voting for significant tax increases, and of defending their actions to their constituents.

- Indexing guarantees Congress automatic revenue growth, whether or not additional revenue is actually needed. Incentives for fiscal restraint are eliminated.

If the federal tax on beer drinkers does not automatically increase, does that mean that they are getting a "free ride"? Absolutely not. Since 1951, state and local tax revenue derived from beer sales has increased by approximately 564%, reaching a level of $2.5 billion in non-federal excise taxes and sales taxes.

Moreover, this revenue is of great importance to state governments. Colorado Governor Richard D. Lamm, lead governor for tax reform, National Governors' Association, commented on the indexing portion of the Staff Option:

> "When federal alcohol, tobacco, and motor fuel excise taxes are indexed to increase with inflation, it creates a permanent preemption of an important source of state tax revenues. State alcohol, tobacco and motor fuel taxes were $19.4 billion in 1984 -- the third largest source of state revenues. This proposal would preempt over $13 billion of these revenues over five years."

History has demonstrated that indexing causes severe problems on the spending side of the ledger. Why, then, should the government introduce that same problem on the taxing side? Why remove one of the major responsibilities of government from the light of public scrutiny?

"EQUALIZING" WINE EXCISE TAXES
TO THE LEVEL OF BEER

One element of the proposed tax reform plan would "equalize" the tax rate on wine and wine drinkers ... raising it to the level of beer and imposing more than a four-fold increase. The brewing industry would not be directly affected by this increase, but its members oppose all forms of higher excise taxes -- particularly those that are prompted by the ill-founded notion that taxes should be based on the amount of alcohol in a beverage.

Some claim that "a drink is a drink is a drink" -- and that, therefore, all alcoholic beverages should be taxed the same. But the use of differential tax rates on beer, wine and liquor is consistent with the tax policies of the democratic nations of the world, and with 200 years of legislative and regulatory tradition in this country.

Beer, wine and liquor are simply different products with different consumers, different physical properties, and different impacts on the nation's economy. To reverse proven policy in favor of so-called "equalized" tax rates would be a major mistake in the nation's alcohol and taxing policies.

THE STAFF OPTION TAX PROPOSAL:

A STEP IN THE WRONG DIRECTION

The proposal currently before the Finance Committee is bad policy and sets bad precedents:

- If excise taxes can be eliminated as a normal business expense, virtually every other cost of doing business can be subjected to the same treatment.

- Similarly, by attempting to apply a false notion of "equalization" to the tax rates for alcoholic beverages, the proposal would undo 200 years of alcohol policy in this nation ... and ignore the most basic precepts of progressive tax equity.

- Even more importantly, however, the proposal would increase the federal government's reliance on excise taxation. Yet if the true intent of the Committee is tax reform, excises and tariffs should continue to go down as a percent of total federal revenue -- not increase.

Excise taxes are hidden. They are inefficient. They are regressive. They are arbitrary. And they are focused unfairly on just a few industries. On every count, they represent a negative influence on the tax code. The nation's reliance on them should not be increased in any way. The Staff Option should be rejected as unsound economic and public policy.

ANHEUSER-BUSCH COMPANIES

August A. Busch III
Chairman of the Board
and President

April 22, 1986

The Honorable George J. Mitchell
United States Senate
Washington, D.C. 20510

Dear Senator Mitchell:

We appreciated the opportunity accorded the Beer Institute to testify before the Senate Finance Committee yesterday. We recognize the many difficult decisions that you and your colleagues confront in addressing the issue of tax reform.

During the course of Monday's proceedings, you asked that all members of the second panel which appeared before the Committee offer their views on an ad valorem approach to the taxation of beer, wine and liquor. Given the severe time constraints to address this question during the hearing, we wanted to provide you, and other members of the Committee, with a more detailed response which may help to clarify the position of the Beer Institute on this issue.

For the following reasons, we oppose converting of beer excise taxes from a volume basis to an ad valorem basis:

- o Collection of such a tax would be plagued with severe problems. To cite a few:

    - -- If the tax were collected at the retail level, this would entail policing more than 500,000 small businessmen, selling hundreds of products priced and taxed at different rates. This approach would also create substantial (possibly ruinous) administrative and overhead costs for these retailers.

    - -- Shifting the collection point to the brewer or wholesaler would require significant additional costs in terms of recordkeeping and reporting. Additionally, this method of taxation would be enormously complex ... and unevenly distributed to consumers ... since most brewers do not have uniform FOB's. And, because brewers and wholesalers regularly promote the sale of various brands and package types through temporary price reductions, the recordkeeping will be even more unwieldy.

    Due to the factors cited above, the federal tax on a national brand will vary widely from one market to another, and from one month to the next.

- An ad valorem approach would penalize the producers of high quality products by forcing them to pay a higher tax rate. In this context, it is noteworthy that the industry's largest brewer -- Anheuser-Busch -- is not its low cost producer. It is difficult to see why the tax code should disrupt the marketplace by encouraging consumers to purchase one brand over another.

- Since the tax would be levied as a percentage of the product price, it would inevitably rise as increased labor and raw material costs force prices to go up. While technically the tax would not be "indexed," the ad valorem approach would have the same inherently inflationary effect over time as indexing.

- Finally, given the highly regressive nature of beer excise taxes, the problems noted above would be particularly unfortunate. After all, we should remember that, far from being indexed over time, similar taxes have been removed from such luxury items as furs, jewelry, perfumes, silver bullion and slot machines.

Once again, thank you for allowing us to express our views on the draft bill and the ad valorem issue. If we can provide you with additional information, please contact us.

Sincerely,

August A. Busch III

STATEMENT OF TONY DEBEVC, PRESIDENT, ASSOCIATION OF AMERICAN VINTNERS, MADISON, OH, ON BEHALF OF THE WINE INSTITUTE AND THE GRAPE GROWERS OF CALIFORNIA

Mr. DEBEVC. Thank you, Senator Packwood and committee. I am privileged to represent the U.S. wine industry, with support from the Wine Institute, the Association of American Vintners, for which I am president, the Wine Grape Growers of America, Oregon Winegrowers, Washington Wine Institute, and on behalf of all American grape growers.

We have experienced a 6 percent decline in table wine sales over the last 2 years; a change from the traditional method of taxation is unwarranted and unjustified.

The claim that the rate increase would make excise tax on wine equal to that of beer is incorrect. The proposed 12 percent table wine tax of 85 cents would in reality be three times the beer rate of 29 cents per gallon. The actual result would be a regressive 410 percent rate increase, and singles out only wines.

The proof gallon concept formula establishes such a bad precedent that the beer industry, not facing a tax increase, has united with us in opposition.

The American wine industry is still in its infancy, and in addition to the older, more traditional producing areas, hundreds of family wineries are merging in 34 States. Even without future Federal excise increases, they face economic hard times, falling sales, plummeting land values, and enormously high excise taxes at the State level.

With 90 percent of the wine sold in the United States priced under $3 per bottle, these huge excise tax increases on table wines would be passed on primarily to the lower and middle income consumer.

We believe taxes should be based on the ability to pay, not formulated to reduce the income taxes assessed to people who can afford to pay them.

In 1951 we did not have foreign competition after the war. The pressed use sales were in their heyday, low production costs, and of course sales taxes have gone up considerably since then.

Since 1975 the market share of foreign wines has grown from 17 percent to a whopping 30 percent. The increase has resulted mainly from foreign subsidies and the overvalued dollar, especially in the lower price ranges.

In 1985, the trade deficit on wine was approximately $1 billion. Gentlemen, we are not $1 billion less competitive in this country.

While these proposed increases will apply to all wines, many foreign governments would surely absorb the excise and duty increase. Thus, the impact will be much more severe on the American producer and our balance of trade. It will continue to further deteriorate the U.S. share of the market from the present 70 percent to an estimated 65 percent. Moreover, the American industry has been seriously impeded by the discriminatory tariff and nontariff trade barriers in its export drive to the open seas market.

The proposed tax would result in an estimated 15-percent loss in American wine sales, amounting to 62 million gallons, or $375 million. This translates in the loss of 400,000 tons of grapes, 50,000 acres of vinyards, and unemployment estimated at 17,000 full- and part-time workers coast to coast. The forced sale and closing of some 400 vinyards would cost more unemployment.

In 1985, the Federal excise tax on all wines, American and foreign, generated $276 millioo. Yet, the commitee staff projects $3.5 billion in additional revenue over the next 5 years for this tax rate provision alone. The unreality of squeezing such money out of a faltering industry and hard-pressed consumers is readily apparent.

The proposal would create an administrative nightmare. The present system, a simple system of 17 cents per gallon for table, 67 cents for dessert wines, and $3.40 for champagne would be replaced by a complex formula for every single alcohol percentage. BATF would have to add so much manpower to effectively administer this new Tax Code that an economic impact projection would be in order.

The American wine industry is heavily regulated to protect the health of the American consumer. This is not always the case in foreign wines, as evidenced by the recent scandals. Just last week, on Friday, the Italian Government approved 50 billion lire to improve the Italian image of wine in the United States. That is subsidies.

Our agricultural-based industry should not be severely weakened by unreasonable tax policies.

In closing, gentlemen, the decision you make here today will determine our industry's future. My grandfather immigrated from Yugoslavia in 1914, working his way to Ohio vinyards in 1916. My father, mother, my wife, and I started our winery in 1971, to continue the tradition so that our children could be the fourth generation to work our laod. We are typical of the American family winery; the Falcon Crest image is not realistic. Television makes it appear that money is no object and that manual labor is only performed by the hired help. In reality, the entire family participates in all phases of our vinyard winery operations—in the fields, in the cellars, in the salesrooms, and the wider market place. Often family purchases are delayed so that much needed tanks or presses can be replaced or added.

We are hard-working farmers in search of the American dream, and our winery, like so many others, will not turn a profit if these proposed taxes are enacted.

Vinyards take 5 years to reach maturity once abandoned, and they cannot be replaced to reproduce the next season. With one stroke of your pen, you can increase our taxes. But if your decision is wrong and you rescind them in the future, it will be too late for many in our industry.

Thank you.

The CHAIRMAN. Thank you.

Dr. Jacobson.

[The prepared written statement of Mr. Debevc follows:]

HEARINGS
ON THE
FEDERAL EXCISE TAX ON WINE

BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

APRIL 21, 1986

STATEMENT
OF
ANTHONY P. DEBEVC
PRESIDENT
ASSOCIATION OF AMERICAN VINTNERS

My name is Tony Debevc. I serve as President of the Association of American Vintners, a voluntary non-profit organization of wineries. Our more than 100 members have wineries in 26 states. I am also a third generation winegrower from the state of Ohio. Because of the limitation of time, and the request for consolidated testimony, I am privileged also to speak today on behalf of the Wine Institute, with more than 500 wineries in California, the Wine Grapegrowers of America, Inc., on behalf of wine grape growers, as well as all of the state and local associations throughout our nation which are comprised of vintners and farmers who are grape growers. I am here today hoping to convince you to save my vineyard and winery, and that of three to four hundred other grape growers and winery owners who we believe will be forced out of business by the Chairman's proposals before the Senate Finance Committee.

Your proposals are (a) to increase the federal excise tax rate on wine more than 400%, (b) to disallow the deductibility for excise taxes, and (c) to index future excise tax rates on any increases in the cost of our products. This program singles out wine alone, within all excise categories, for an outright tax rate increase and would include a radical new taxing formula for wine, unprecedented in our history and that of other nations, tied to a "proof gallon" concept which would increase the average wine tax to three times that of beer. The discriminatory rate change is expected to increase federal tax revenues by $3.5 billion over a five-year period.

In the name of revenue neutrality and tax reform, you are being urged to enact tax legislation that will spell economic ruin for an agricultural sector that neither receives nor seeks federal subsidies. We have compiled an index of hardship, after much consultation with economists, suppliers, consumers and bankers. The price tag is truly punitive: (1) A reduction in American wine sales of over 10%,[1/] approximating 50 million gallons annually. This over 10% drop in sales would translate into a 350,000 ton loss in grape sales.[2] (Reputable economists believe these figures to be conservative and have projected a loss in American wine sales, 15% to 20%, amounting to 62 million to 82 million gallons, worth between $372 million and $492 million. Their calculations include a loss of 415,000 to 547,000 tons of grapes.) (2) Economic abandonment of between 50,000 to 70,000 acres of grapes, resulting in unemployment for an estimated 17,000 full and part-time farm workers coast-to-coast.[3] (3) The forced sale or closing of some 400 vineyards,[4] causing more lost employment -- as many as 1,000 skilled employees and 1,000 laborers.[5]

The potential for capital loss from abandonment of vineyard and wineries is in the hundreds of millions of dollars.[6] Lost wage income is estimated to be $98 million annually,[7] and lost farm and winery sales are estimated at $252.5 million annually.[8] Annual supplies not purchased by wineries is estimated at $125 million, and supplies not purchased by vineyardists at $35 million.[2] Over the five-year period, lost wages and lost farm, winery and supplier income would amount to close to $2 billion.

These numbers will not return, by the way, if Congress, by another stroke of the pen, says "Okay, you've had enough!" Vineyards are a long-term investment. It takes five years to bring a vineyard into bearing at a cost of $5,000 per acre, and more incentive to start a winery than is warranted by the economics of the process today. Unlike an industrial or some other agricultural operations, a vineyard cannot be put in storage, nor can the crop be simply plowed under like corn, wheat, and other agricultural commodities.

I am sure that the wine and grape growing community must seem small, even perhaps irrelevant compared to trucking, petroleum, travel, and other industries that are affected by your proposals to reallocate America's tax burden. Or perhaps it is that the "Falcon Crest" television image of winemakers makes it appear that money is not an object. The social, cultural and economic realities, however, are quite different and instructive.

For example, at this moment, wine and wine coolers are both participants in and beneficiaries of the national trend toward moderation in all things. Health conscious Americans are consuming beverages with less alcohol, as they have become increasingly alert to nutritional values and sense of personal self-improvement. But foreign governmental fiscal and trade policies, and currency fluctuations, revolving around the over-valued dollar, have put our firms and families at an artificial competitive disadvantage. The comparative attraction of our high-quality standards -- made all the more evident by recent wine scandals in Europe -- and our competitive price and marketing skills have been thwarted by governmental intrusions and pressures.

This last decade's increased consumption of wine and wine coolers has also witnessed in America major penetrations by foreign wines, as we have had to fight strenuously to overcome tariff and non-tariff barriers overseas. In the important table wine category, the foreign share of this market advanced from 17% to 30%, for reasons unrelated to quality and efficiency. As the United States International Trade Commission reported in October 1985, "Domestic shipments of non-premium table wine declined nearly 7 percent during 1982-1984, from 263 million in 1982 to 245 million gallons in 1984." In 1985, the balance of trade deficit for wine reached almost $1 billion. Mr. Chairman and members of the Committee, we know we are not a billion dollars less competitive than foreign firms.

There are more than 1,200 wineries in the United States[10] -- 30% of them are less than 6 years old[10] -- 79% of them are family owned -- 1,000 of them produce less than

15,000 gallons a year -- 80% of them are losing money[11] -- 86% of their grape growing partners are losing money.[11] Over 1,000 of the 1,200 total are small businesses, primarily owned and operated by families, who raise their own grapes and make their own wine.

In the last decades we have had good vintages. The crops have been abundant and the quality has been excellent. But the over-valued dollar, foreign governmental subsidies, and an open-door trade policy combined to reduce the U.S. share of market to 70%. Last year, the duty-free importation of "five-fold" 6X grape concentrate, unfairly competing with U.S. produced grapes, increased to the equivalent of 37,000,000 gallons of single strength juice, compared to 5,500,000 gallons in 1982.[11] In Canada, a few miles north of the states of New York and Washington, the Canadian Provinces guarantee their winegrape producers at least 90% parity for their juice and a guaranteed contract price of $400 a ton.

Therefore, despite the predictions of bankers and economists 5 years ago that our American industry should be in a steady 6% per year growth phase, the reality is that this is a wine and grape industry poised on the point of implosion. The Packwood proposals, if enacted, will precipitate ruin. The status quo on taxes, and a more favorable change in the strength of the dollar could give us a fighting chance.

All segments of the American wine economy, including our major banks, are experiencing severe financial pressures. The price of grapes in the major growing districts of the San Joaquin Valley in California, for example, has declined dramatically in the last three years to a level that is well below the cost of production for most farmers. Since 1982, grape prices in Districts 13 and 14 there have declined from $137.02 a ton to $94.60 a ton. We estimate that an efficient farmer needs about $140 a ton to service debt and break even. The Packwood proposals for wine, not counting "indexing," would levy the equivalent of $243 a ton of new fiscal burdens.

Against this backdrop, we would suggest that your staff's analysis of the present law is fundamentally flawed and underscores its lack of understanding of our industry. The Finance Committee's report of March 18, 1986 says that under present law "wine is taxed at different rates depending on the alcohol content of each type of wine." This is simply incorrect. The truth is that the still wine category taxed at $.17 per gallon includes such products as: wine coolers that have an alcohol content of 4%-7%; popular table wines, such as chablis and burgundy, with an alcohol content of 10%-14%; and premium varietals, such as chardonnay and cabernet sauvignon, with an alcohol content of 10%-14%.

The still wine category taxed at $.67 per gallon includes such types of products as port and sherry, with an approximate alcohol content of 18%, and vermouth, with an alcohol content of 17%-21%. The category that is grossly misunderstood, and proves the flaws in the entire "proof gallon" approach, is champagne and sparkling wine. While processing the same alcohol content of table wine at 10%-13%, such products are taxed at $3.40 per gallon.

Further elaboration on this point will convince even the strongest skeptics that the wine tax rate increase proposal inherently lacks credibility. Accompanying the Finance Committee analysis of the present law is another incorrect reference that "wine containing 12% or less alcohol is subject to tax at a lower rate than beer on a proof basis." This is patently erroneous in that the current tax on champagnes and sparkling wines, on a proof gallon basis, is the highest of all alcoholic beverages, even exceeding distilled spirits.

People unfamiliar with our industry and nomenclature and products are unaware that the champagne tax of $3.40 per gallon, for a typical sparkling wine at 12% alcohol content by volume, converts to $14.17 a proof gallon equivalent. The proof gallon equivalent of beer, from 4% to 6% alcohol by volume, is $2.42 to $3.63. The distilled spirits tax is $12.50 per proof gallon. Thus, in keeping with the proposal that "the tax rate on wine having alcoholic content of 21% or less would be increased to a rate equivalent to the proof rate presently imposed on beer," the fiscal logic would lead to a dramatic reduction of the $3.40 champagne tax to $.87 per gallon for 12% champagne and sparkling wines.

Major producers and marketers of champagne would certainly welcome the reduced tax structure, but we doubt that the proposed legislation intends to lower any tax rates. We see this contradiction as a fundamental, analytical and fiscal flaw in the tax rate proposal.

Our wine/grape community needs help desperately. If I and other members of the wine and grape industry had our way, we would not ask you for the same kind of subsidy there is, for example, on grain. We would not ask for grape price supports, nor for money to pull out our vineyards or harvest our grapes into the ground. Wine is an agriculturally based commodity that does not receive any government subsidies, and we don't want any. We would tell you that excise taxes are a bad form of consumer taxation, and that they should be ended for wine. A good number of my colleagues would honestly rather pay income taxes -- taxes we make on our legitimate earnings -- than have you tamper with the foundation on which our consumer prices rest.

Moreover, the necessary change in regulations alone by the Bureau of Alcohol, Tobacco & Firearms would lead to an administrative nightmare.[11] Let me explain by using the dominant table wine category of wines under 14% alcohol by volume: Under the present law the determination of tax liability is simple. We know that the full range of our chablis, burgundy, rose, cabernet sauvignon, zinfandel, white zinfandel, etc., are always under 14% alcohol by volume from one day to the next. We determine our tax liability by simply multiplying the number of cases we ship each day by the standard number of gallons in each case to determine the aggregate number of gallons shipped. We pay taxes on a semi-monthly basis by period and applying the tax rate of $.17 per gallon to the cumulative shipments. The same procedure applies to determining the tax liability for shipments of wines over 14% and less than 21% and to the champagne/sparkling wines category.

This straightforward and simple method would be rendered inoperative by the passage of Senator Packwood's wine tax proposal. In the blending, processing and preparation of wines for bottling, it is common for the alcohol levels to increase or decrease due to technical variables far too numerous to explain in this setting. These variables are recognized by government labeling regulations which provide for bottling tolerances of 1$^{1/2}$% alcohol by volume for wines under 14% and sparkling wines and champagnes; and 1% alcohol by volumes for wines over 14% and under 21%.

In practice, therefore, a 12% chablis label can actually have 10$^{1/2}$% one day, 11% another day, and 11$^{1/2}$% another day, ad infinitum for every type of wine we market. The situation can become even more complex when we consider that in the course of one day's bottling we may bottle several different blends of a particular wine type into different container sizes; these blends can all differ in alcohol content. The present system can easily accommodate these differences. The proposed new one simply cannot.

The wine industry would actually be forced to change its wine making procedures, to a batch by batch basis, altering its entire tank, bottling line, and trucking requirements at great economic costs. ATF would have to add so much manpower to administer the new taxing code, percentage by percentage by percentage, that perhaps it would be in order for your

Committee to seek an economic impact projection by the Bureau as to its administrative capabilities to oversee the new tax code changes.

Finally, we have up to now essentially stressed the likely devastating effect of the proposed tax increase on wine only. We must also consider the costly and inflationary consequences of the non-deductibility and indexing features on other products and industries, such as gasoline, heavy trucks, airline tickets and telephone services. The burden of these excise/consumption tax increases will be passed on to the consumers of these goods and services.

We are among those consumers. For example, the trucking industry will be severely impacted. Its services are critical to our growers and vintners: in moving grapes from the vineyards to our wineries to be converted into wine; in hauling our bulk wines and other winery products from one winery to another for storage and/or processing and/or bottling; in delivering empty bottles from the manufacturers to the winery plants; in delivering finished case goods and promotional materials to the wholesale and retail trade throughout the United States.

Our analysts estimate that in 1985 all this transportation activity represented some 850,000 truck loads at a cost of approximately $530 million. Senator Packwood's proposals would, if enacted, obviously increase our trucking costs and have a further regressive effect on us and our consumers.

This dimension of regressivity -- increasing taxes not based on the ability to pay in order to reduce income taxes that are based on the ability to pay -- invalidates the entire excise tax program now before the Senate Finance Committee.

Besides devastating the American wine industry, that program would cripple or, in some cases, completely eliminate, the vibrant tourist trade and related businesses which winegrape growers and small vintners have been responsible for engendering in many rural areas. The death of these small vineyards, and the revenue they generate for local restaurants, hotels, and personal services would be catastrophic for many small communities.

I would like to close on a personal note. I mentioned earlier that I am a third generation wine grower. My grandfather emigrated here from Yugoslavia to start our vineyard. My father, my mother, my wife and I started our winery so that our children could be the fourth generation to work this land. I believe in the American dream, so I want to believe that their future is still promising. But I would not forgive those who took their future away.

If I and others like me can get on with the job of providing one glass of wine a day to each adult, which, by the way, would quadruple the per capita average, the federal government will get its $3.5 billion and more. If you adopt your current proposals, you will receive far less than what you project and at a cost to our industry beyond tax rates and dollars.

Respectfully submitted,

Anthony P. Debevc
Association of American Vintners

FOOTNOTES

1/ Falwell, Raymond J. and Stephen Lutz, Department of Agricultural Economics, Washington State University, Pollman, April 3, 1986.

2/ Estimated vineyard impact: actual tonage is 350,000 equivalent to 70,000 acres lost production. This size surplus is estimated to drive prices so deep as to have 5X economic effect.

3/ Cornell University Department of Agricultural Economics; 1 full time equivalency (FTE) per 20 acres.

4/ AAV estimate: combination of inability to buy bond and price competition.

5/ AAV estimate: 5 employees per winery average.

6/ Average winery value estimated at $100,000; vineyard at $5,000 per acre.

7/ Farm FTE estimated at $4,000; skilled winery at $20,000; unskilled at $10,000.

8/ 350,000 tons not purchased at $150; 1,400,000 purchased at $75 below fair market value; and 50 million gallons of wine not sold at $2.50 per gallon.

9/ Supplies: winery equals $1.50 per gallon; vineyard equals $100 per acre.

10/ AAV data.

11/ International Trade Commission study report by Hartzell, dated April 9, 1986, to the Joint Economic Committee hearing.

12/ California Association of Winegrape Growers, dated March 1986.

13/ See attached Schedule.

STATEMENT OF MICHAEL F. JACOBSON, PH.D., EXECUTIVE DIRECTOR, CENTER FOR SCIENCE IN THE PUBLIC INTEREST, WASHINGTON, DC

Dr. JACOBSON. Good morning.

Thank you very much for this opportunity to testify before the committee.

I am the executive director of the Center for Science in the Public Interest, a nonprofit health advocacy organization. I am also representing the National Alcohol Tax Coalition, which is made up of dozens of local and national groups ranging from the Oregon State Council on Alcoholism to the National Association of Junior Leagues to the American Association of Retired Persons.

We support higher taxes on alcoholic beverages to reduce alcohol problems.

Currently, alcohol causes devastating health, social, and economic problems. Alcohol contributes to between 100,000 and 200,000 deaths a year. In economic terms, alcohol imposes costs on our society amounting to $120 billion a year.

The Federal Government experiences costs of $25 billion a year due to problems related to alcohol. That is five times the amount collected in excise taxes each year.

Though alcohol may be America's No. 1 hard drug, Federal alcohol taxes have remained almost immune to increases. Beer and wine taxes have not been increased since 1951. The liquor tax was increased last year, but only by 19 percent.

The result? The real price of alcoholic beverages has been declining, particularly relative to nonalcoholic beverages. A six-pack of beer is often cheaper than a six-pack of soda pop. Think of the message that that sends to American teenagers.

Higher taxes would increase beverage prices somewhat and would help reduce abusive drinking. Raising taxes would also generate billions of dollars in new Federal revenues.

The National Alcohol Tax Coalition report examined several different scenarios, and if I may, I would like to offer a copy of the report for the hearing record.

The CHAIRMAN. Without objection.

[The data follows:]

IMPACT OF ALCOHOL EXCISE TAX INCREASES ON FEDERAL REVENUES, ALCOHOL CONSUMPTION, AND ALCOHOL PROBLEMS

by

National Alcohol Tax Coalition
1501 16th St. NW
Washington, DC 20036
(202) 332-9110

September 18, 1985

I. Introduction

Alcoholic beverages are among a small group of products on which special federal excise taxes are levied. Though the taxes are sometimes derided as old-fashioned "sin taxes," there are good reasons why this group of beverages (along with cigarettes) has been singled out for what might also be called "health taxes." Alcohol is a factor in 100,000 to 200,000 deaths each year, according to the National Institute on Alcohol Abuse and Alcoholism (NIAAA).[1]

While the tragedies of drunk driving are well-known, alcohol is also related to half or more of all drownings, child and wife abuse, rapes, and homicides. Alcohol affects practically every organ in the body and, in sufficient quantity, causes brain damage, liver cirrhosis, birth defects, heart disease, and cancers of the liver, mouth, throat, esophagus, and larynx. The harm alcohol causes in the form of broken families, ruined careers, and school failure is incalculable. According to studies sponsored by the congressional Office of Technology Assessment and the Alcohol, Drug Abuse, and Mental Health Administration (ADAMHA), alcohol problems result in direct and indirect costs to society of $120 billion annually.[2] These dollar costs include health care costs, reduced productivity, and social welfare programs, among other factors. It is no wonder that alcohol is considered by many experts to be the number one drug problem in America.[3] Levying special taxes on alcoholic beverages needs to be considered in the context of these societal costs.

While alcohol problems saddle individuals, families, and employers with huge costs, they also engender substantial costs to the federal government. These costs include (a) direct expenses for treatment of sickness and injuries through Medicare [4], Medicaid, Indian Health Service, Department of Defense, and health insurance premiums for federal employees, as well as the entire budget of NIAAA; (b) loss of productivity among federal employees, due to sickness and death related to alcohol; (c) reduced income tax revenue due to reduced productivity in the private sector. No comprehensive study of these direct and indirect costs has been conducted, but it would appear that they total upwards of twenty billion dollars a year.[5] One can look upon excise taxes as partial reimbursement to the government for these various costs of alcohol problems.

During much of America's recent history, excise taxes on alcoholic beverages provided a substantial percentage of federal revenues: over 11 percent in 1941 and 5 percent in 1951.[6] In stark contrast, the $5.4 billion in alcohol excise taxes collected in 1984 provided only 0.8 percent of total federal revenues.[7]

Federal excise tax rates imposed since 1934 are listed in Table 1. While tax rates remained constant between 1951 and 1984, inflation greatly reduced the value of the tax dollars. As shown in Table 2 and the Figure (see next page), taxes (expressed in 1984 dollars) on all three types of alcoholic beverages -- beer, table wine, and liquor -- are lower, in real terms, than at any time since the repeal of Prohibition. At the height of World War II, taxes, in terms of purchasing power, were about five times higher than at present.

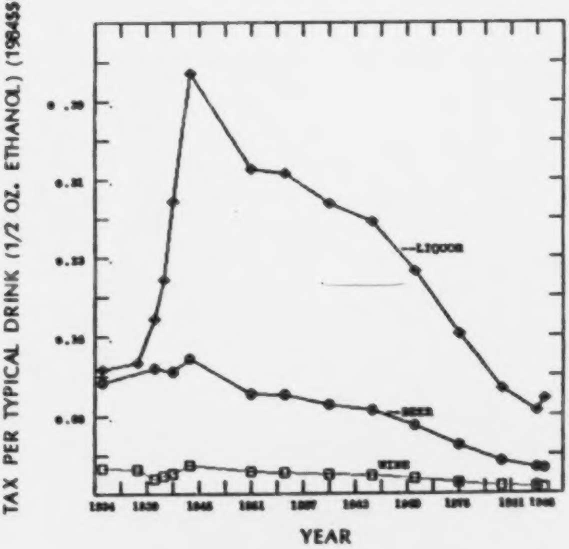
After the modest 1951 tax increases (12-16 percent) that helped finance the Korean War effort, rates remained constant for several decades, while inflation gradually shrank the value of the dollar by about seventy-five percent. In fact, if excise taxes had been linked to inflation, the federal government would have garnered an additional $105 billion between 1952 and 1984 (1984 dollars), assuming sales had remained constant, or perhaps $40 billion to $75 billion if sales declined because of increases in absolute prices.[8]

Table 1 Federal Excise Taxes on Alcoholic Beverages (actual dollars)

DATE	BEER (gallon)	WINE (gallon)	LIQUOR (gallon - 100 proof)
Jan., 1934	$.16	$.10	$ 2.00
July 1, 1938		.10	2.25
July 1, 1940	.19	.06	3.00
Oct. 1, 1941		.08	4.00
Nov. 1, 1942	.23	.10	6.00
Apr. 1. 1944	.26	.15	9.00
Nov. 1, 1951	.29	.17	10.50
July 1, 1984	.29	.17	10.50
Oct. 1, 1985	.29	.17	12.50

Table 2 Federal Excise Taxes (expressed in 1984 dollars)

DATE	BEER (gallon)	WINE (gallon)	LIQUOR (gallon - 100 proof)
Jan., 1934	$1.27	$.79	$15.71
July 1, 1938		.74	16.55
July 1, 1940	1.43	.44	22.22
Oct. 1, 1941		.54	27.17
Nov. 1, 1942	1.40	.62	37.18
April 1, 1944	1.54	.89	53.54
Nov. 1, 1951	1.14	.67	41.35
July 1, 1984	.29	.17	10.50
Oct. 1, 1985	.28	.16	11.97



TAXES ON BEER, WINE, LIQUOR (1934 - 1985)

FIGURE

In 1984, with budget deficits soaring to records highs, Congress turned once again to alcohol taxes as a source of revenue. Congress raised the tax on hard liquor by 19 percent (as of October 1, 1985), but left untouched the taxes on beer and wine.[9] With huge deficits straining the U.S. economy, and putting tremendous pressures on social programs for the poor, the possibility of additional alcohol tax hikes remains a viable -- and increasingly inviting -- political option.

Increasing the excise taxes on alcohol does more than raise revenue. Because higher taxes mean higher prices, they also lead to reduced drinking.

Scholars have studied the relationship between taxation and prevalence of alcohol problems. For example, Philip Cook, professor of public policy studies and economics at Duke University, has shown a correlation between state liquor tax increases and reductions in the rates of liver cirrhosis and auto fatalities.[10] Thus, while the reduced consumption of alcohol partially offsets the revenue-enhancing effect of tax increases, it can provide major health and social benefits to society.

The government of Sweden has mounted a multi-faceted effort to reduce that nation's drinking problems. According to the Swedish government, "The taxation of alcoholic beverages has long been of great importance for the national budget, and it has also served as perhaps the most powerful instrument of a temperance policy designed to keep consumption within reasonable limits."[11] Similarly, the U.S. NIAAA reports that:

> Lowering the alcohol consumption levels is associated with reduction in a number of adverse effects of drinking such as alcohol-related traffic accidents (especially by youth) and diseases such as cirrhosis of the liver. Some effective efforts, documented through research, are increasing taxes on alcoholic beverages....[12]

The practical effect of current policy -- keeping excise taxes stable -- is that true alcoholic beverage prices tend to rise more slowly than inflation, thereby contributing to increased consumption. According to Cook:

> Between 1967 and 1983 the real price of alcoholic beverages, adjusted for overall inflation, declined 27 percent. Distilled spirits have led the way with a 48 percent decline in average price, followed by beer with a 25 percent fall and wine with a 19 percent reduction.[10]

Those "real price" declines have made alcoholic beverages ever more competitive with soft drinks and other beverages for the consumer's dollar. As Mosher and Beauchamp have pointed out,

> [S]ince 1970 ... a $5.00 purchase of an alcoholic beverage increased to $10.83 in 1983, while a $5.00 purchase of a nonalcoholic beverage increased on the average to $21.56 during the same period.[13]

The static excise tax component was a significant, but not sole, factor in moderating the price rises for alcoholic beverages.

The comparatively lower prices of alcoholic beverages are particularly important in the purchasing decisions of youths, who are responsible for a disproportionate number of fatal and non-fatal automobile accidents. Michael Grossman and Douglas Coate of the National Bureau of Economic Research and Gregory Arluck of the New York Telephone Company, have written:

> The reduction in real alcoholic beverage prices since 1960 or 1976 due to the stability of excise tax rates is inconsistent with the goals of discouraging alcohol abuse and reducing motor vehicle accidents and deaths. Indeed, government policies actually may be making these problems worse.[14]

One argument made against increasing excise taxes is that such taxes, like sales taxes, are regressive, affecting low-income people more than middle- and upper-income people. For several reasons, we cannot give much credence to this concern. According to a 1977 U.S. Department of Agriculture survey, households earning under $10,000 per year spent less than 90 cents per week on alcoholic beverages, while households with incomes over $20,000 spent $2.82 per week.[15] For the one-tenth of the population with the lowest incomes, expenditures for alcohol represent only about 0.2 percent of total income.[15] Also, alcoholic beverages can hardly be considered necessities and therefore worthy of exemption from taxation. Excise taxes penalize not poor people, but all drinkers, who are taxed, fairly, in direct proportion to the amount they drink and, on the average, to the amount of damage they cause to their families and society. For light drinkers, who constitute one-third of the population and consume little more than one drink per week, the cost of even a major tax increase would be only a few dollars a year, while non-drinkers -- 36 percent of adults -- would pay nothing at all. Finally, the fact that Children's Defense Fund, Children's Foundation, the American Association of Retired Persons and other organizations concerned about low-income people support increased excise taxes further indicates that regressivity is not a paramount consideration in this matter.

A second argument against raising federal excise taxes is that, because of reduced sales of alcoholic beverages, states would receive less revenue from their own taxes. This is true, but could be remedied easily by either compensatory increases in state taxes or by revenue sharing. A national increase has a substantial advantage over helter-skelter increases in state taxes: consumers are not given an incentive to drive across borders to buy lower cost products, as happens when a state raises its taxes higher than bordering states.

* * *

Revenue-seeking legislators and prevention-oriented alcohol experts have proposed various forms of tax increases:

1. Raise taxes to correct the diluting effect of inflation since 1951. A 1951 dollar was worth only 25.4 cents in 1984. Therefore, adjusting for inflation would roughly quadruple the current tax (292 percent increase).

2. Raise beer and wine tax rates to equal (on a per unit alcohol basis) the rate at which liquor is taxed. Equalizing the taxes would quadruple the tax on beer and increase by seventeen-fold the tax on wine.

3. Double all the alcohol taxes.

4. Some combination of these, such as correcting for inflation and equalizing the rates.

In projecting the overall impact of various tax increase possibilities, several factors must be considered, including:

(a) to what extent will tax increases affect prices?

(b) to what extent will the higher prices reduce sales?

(c) to what extent will reduced sales reduce the level of alcohol abuse and alcoholism?

After considering each of these questions, we will present our projections of the effect of tax increases on tax revenues, alcohol consumption, and alcohol problems, followed by our recommendations.

II. Estimates of Key Variables

(a) To what extent will tax increases affect prices?

There is little agreement on how tax measures would affect beverage prices. One could assume, naively, that prices would be increased by an amount equal to the tax increase. That is, a $1 per gallon tax increase on liquor would increase the price by $1. Industry observers, however, note that wholesalers and retailers apply a standard mark-up to the prices they are charged by suppliers, not distinguishing between the base price and taxes. They also suggest that companies may try to maintain profits, in the face of higher prices and lower consumption, by raising prices more than the actual value of the tax. Beverage Management Resource Group (BMRG) predicts mark-ups on the tax increase of 58 percent for liquor, 100 percent for table wine, and 81 percent for beer.[16] (Apparently, BMRG believes that the smaller the tax increase, the easier it would be to pass it through to the consumer with a full mark-up; liquor is taxed more heavily than beer which is taxed more heavily than wine.) That is, a $1.00 increase in the tax on a bottle of liquor would lead to a $1.58 increase in the price.

Others suggest that since the tax does not represent a "real" production or distribution cost, it could be passed on without any mark-up at all. Also, competition would serve to minimize, or at least moderate, the mark-up. Cook estimates a mark-up on liquor of only 18-20 percent [17] while Jeffrey Harris of M.I.T. assumes no mark-up.[10] The Department of Treasury's Office of Tax Analysis has estimated a straight pass-through of the tax increase plus interest costs to finance the higher prices of merchandise.[18]

We will assume that distributors and retailers will pass the entire tax, plus a 20 percent mark-up, on to consumers. (Appendix II includes projections based on 0 percent and 40 percent mark-ups.)

(b) To what extent will the higher price reduce sales?

Grossman et al. state, "although alcohol use is a behavior that has habitual elements, there is no evidence that this behavior is insensitive to price."[14] All parties agree that price increases will reduce alcoholic beverage sales. A significant number of individuals will drink less frequently; switch to lower-proof liquor, soft drinks, and other non-alcoholic beverages; and drink less on each drinking occasion. But some consumers will "evade" the price hikes by buying less expensive brands of their favorite drinks, but drinking as much as ever. And, if alcoholic beverage prices rise sharply, industry spokesmen have said, bootleg beverages might replace a small fraction of the legally produced products. Actual consumer behavior is impossible to predict with accuracy, but one can be confident that sales will not increase.

Grossman et al. developed a mathematical model to estimate the effect of price increases on drinking by 16-21 year olds. They conclude that modest price increases -- 30 cents (5.6%) for a bottle of liquor and 10 cents (7%) for a six-pack of beer -- would decrease drinking among young people as much as raising the drinking age by 1 year.[14]

The Swedish government has instituted various measures, including advertising bans, drunk driving laws, and higher taxes, to reduce abusive drinking. The Swedes have concluded that higher excise taxes have been the key factor in reducing per capita consumption of alcohol by 21 percent between 1976 and 1983.[19]

The effect of price on consumption is referred to as "price elasticity." An elasticity of -1.0 means that for every 10 percent increase in price, consumption would decline by 10 percent. Several estimates of alcoholic beverage price elasticities are shown in Table 3.

Table 3. Price Elasticities of Alcoholic Beverages

AGENCY/INDIVIDUAL	PRICE ELASTICITY
Distilled Spirits Council of the U.S.[20]	-0.5 (liquor)
OMB/Dept. of Treasury [21]	-0.79 (liquor) -0.3 to -0.4 (beer/wine)
Philip Cook [10]	-1 (liquor)

In a wide-ranging review of the literature, Stanley Ornstein, of the Graduate School of Management, University of California at Los Angeles, concluded that the consensus of reliable studies indicated an elasticity of -0.3 to -0.4 for beer, but that there was no consensus for liquor and wine.[22] The very divergent estimates of elasticities coming out of various, relatively reliable studies (beer, -0.33 to -0.89; wine, -0.44 to - 1.59; liquor, -1.0 to -2.0) indicates the difficulty of predicting accurately the extent to which increased prices would affect sales. These estimates were generally developed from studies of the effects of relatively small state tax increases or by less quantitative means. (The price elasticity of cigarettes falls in the same general range as that estimated for alcoholic beverages.[23])

We are dubious of the very high estimates of price elasticities, because drinking is a deeply ingrained habit and many millions of Americans are addicted to alcohol. Also, we believe price increases would spur many people to switch to less expensive brands. Consequently, we will base projections on an elasticity for all three categories of beverages of -0.35 (i.e., a 10 percent rise in prices will be projected to cause a 3.5 percent drop in sales). (Appendix II includes projections based on elasticities of -0.1 and -0.7.) The choice of price elasticity has a marked effect on estimates of tax revenues and sales.

(c) To what extent will reduced sales reduce the level of alcohol abuse and alcoholism?

Predictions of the effect of reduced consumption on alcohol problems span a wide range. Opponents of tax increases argue that higher prices would discourage buying only by moderate alcohol consumers, while alcoholics and other heavy drinkers would maintain their consumption. Others argue that wealthy people -- heavy drinker or not -- would maintain their level of consumption, while low-income people and youths would decrease their consumption. Yet others maintain that the most straightforward assumption is that alcohol problems would decrease in rough proportion to the declines in consumption.

The argument that addicted drinkers account for the great majority of alcohol-related problems in our society has questionable validity. A National Academy of Sciences panel found that light and moderate drinkers appear to account for about half of all damage related to alcohol.[24] The relatively low frequency of problems that these people cause is made up for by the vast number of people in this group -- ninety percent of all drinkers.

Of course, to the extent that heavy drinkers reduce their drinking, alcohol problems will also decline. Grossman et al. found that the effects of price increases "are not limited to light or infrequent drinkers."[14] Robin Room, of the Alcohol Research Group of the Medical Research Institute of San Francisco, has concluded that "price measures ... appear to affect the heaviest drinkers as much as or more than others, and often result in at least short-term reductions in cirrhosis mortality and other chronic health problems, alcohol-related casualties, and social disruption."[25] In an editorial supporting a ban on alcohol advertising, the editors of Lancet, the British medical journal, wrote:

> The general view is that a fall in per capita consumption is reflected in a greater fall of consumption by heavy drinkers, who of course are those at greatest risk of alcohol-related harm.[26]

Grossman et al. have highlighted the long-term beneficial impact on alcohol problems that would flow from decreased youth drinking:

> Since alcohol abuse in adolescence appears to be associated with alcohol abuse in adult life, policies to prevent the onset of this behavior by adolescents might be the most effective means to reduce it in all segments of the population.[14]

In Sweden, the decline in per capita consumption of alcohol was paralleled by a decline in abusive drinking by youths. Heavy drinking (half a bottle of liquor, or more, at a time) among 16-year old boys also declined significantly (from 40% of boys in the 1970s to 28% in 1981).[27]

Cook and Tauchen have found that increasing the federal liquor tax by 16 cents on a fifth of 80 proof spirits would reduce the rate of cirrhosis mortality by 1.9 percent. Extrapolating from that finding, the authors estimate that doubling the federal liquor tax would reduce the mortality rate by about 20 percent. Jeffrey Harris says that this would "mean a postponement of 6,000 deaths annually."[28]

Predicting the effect that reduced drinking would have on costs to society is impossible to do with any precision, because of a paucity of data. Different costs -- time lost from work, automobile accidents, cirrhosis, spouse abuse, etc. -- would each be affected to different extents, depending on drinking patterns and population sub-groups. For the present purposes, we will assume that alcohol problems will decrease in direct proportion to decreases in alcohol consumption.

III. Results

A model was developed to predict the effects of tax increases on alcohol consumption, tax revenue, and costs to society. (See Appendix I for details.)

The current excise taxes and the taxes that would be levied under five different scenarios for increases are listed in Table 4. Note that the different beverages would be little affected by some proposals, while heavily affected by others. Adjusting for both alcohol content and inflation would result in the greatest increases. Doubling the taxes would have little effect on beer and wine prices and consumption, but a sizable effect on liquor. For the sake of simplicity, only table wine is shown in Tables 4-6; fortified wine is now taxed at $.67 per gallon and naturally carbonated wine at $3.40 per gallon. The latter is currently taxed at a higher rate per unit of alcohol than hard liquor.

Table 5 translates the hypothetical tax rate increases into tax increases for typical products.

The projected effects of tax increases on tax revenues, changes in consumption, and reductions in alcohol problems are indicated in Table 6. (See also Appendix II for calculations based on several different assumptions of price elasticity and mark-ups on taxes.) Note that doubling the current taxes would have the least impact, while adjusting for inflation and taxing all beverages at the liquor rate would have the greatest impact on revenues and consumption. One effect of increasing excise taxes is that consumers would have less money available to purchase other goods and services. Thus, with other companies reporting lower gross sales, their income taxes would be commensurately lower. The Congressional Budget Office considers the average marginal tax rate to be 25 percent.[5c] The "loss of other taxes" in Table 6 reflects this consideration. "Net revenue increase" represents the new income to the federal treasury as a result of raising excise taxes.

IV. Conclusions and Recommendations

Alcohol excise taxes, expressed in constant dollars, are at a 51-year low. If our rising standard of living (inflation adjusted per capita disposable income) were factored in, the current taxes would appear even lower. America's alcohol tax policy has had several clear results: (a) alcohol prices, corrected for inflation, have been declining; (b) this has contributed to increased consumption of alcoholic beverages; (c) the higher consumption has led to increased alcohol problems and increased tax revenues; (d) inflation has reduced by three-fourths the value of the revenue brought in by the taxes.

Politicians, governmental advisory boards, and citizens' organizations are seriously debating whether alcohol (and tobacco) excise taxes should now be increased. After considering historical tax rates, the magnitude of alcohol problems in the U.S., and the impact of higher taxes on alcohol problems and net revenues, we conclude that the net

Table 4 - Tax Rates on Beer, Wine, and Liquor

Tax scenario	Beer (per gal.)	Wine (per gal.)	Liquor (per proof gallon)#
(a) Current rate	$0.29	$0.17	$12.50*
(b) Double current rate	0.58	0.34	25.00
(c) Adjust current rate for inflation	1.14	0.67	49.00
(d) Adjust current rate to equalize for alcohol content	1.13	2.90	12.50
(e) Double + equalize for alcohol	2.25	5.80	25.00
(f) Equalize for alcohol content + adjust for inflation	4.21	11.37	49.00

# "Proof gallon" is one gallon of 100 proof liquor (50% alcohol).

* Liquor tax, now $10.50 per proof gallon, will increase to $12.50 on October 1, 1985.

Table 5 - Tax Increases Per Unit of Sale: Beer, Wine, Liquor*

Tax Change	Beer six-pack	Wine 1/5 Gal.	80 Proof Liquor 1/5 Gallon
(a) No new increase (other than planned liquor tax increase)	-	-	$.32
(b) Double current rate	$.16	$.03	2.32
(c) Adjust for inflation (x3.92)	.48	.10	6.16
(d) Equalize for alcohol content	.47	.55	.32
(e) Double + equalize for alcohol	1.10	1.13	2.32
(f) Equalize for alcohol content + adjust for inflation	2.21	2.24	6.16

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* Tax increases applied at the manufacturing level; mark-ups may be applied as products pass through the distribution chain.

Table 6 -- Projected Effects of Tax Increases*

Tax Change	Increase in Excise Revenues (billions)	Loss of other taxes (billions)	NET REVENUE INCREASE	Change in Consumption	Change in Costs related to problems (billions)
(a) No new increase	$ .61	$ .14	$ .46	- 0.6%	-$ 0.7
(b) Double tax rates	$ 5.7	$1.4	$4.3	- 5.2%	-$6.3
(c) Adjust for inflation	$12.7	$3.2	$9.5	-14.2%	-$17.1
(d) Equalize at liquor rate	$ 6.24	$1.56	$4.7	- 4.8%	-$ 5.8
(e) Double taxes + equalize for alcohol	$15.7	$3.9	$11.8	-13.7%	-$16.4
(f) Adjust for inflation + equalize at liquor rate	$27.3	$6.8	$20.5	-30.2%	-$36.2

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* In comparison to fiscal year 1984.

benefit to society of increases greatly outweighs any costs. Such increases appear to have popular support, according to a 1981 poll by Associated Press: 55 percent of respondents supported higher alcohol taxes, while 41 percent opposed them.

Doing anything about taxes -- or leaving them at current rates -- incurs trade-offs regarding revenues, alcohol consumption, jobs, alcohol abuse, and dollars spent on products other than alcoholic beverages. Two overriding considerations in this political equation are seemingly perpetual $200 billion a year federal budget deficits and the high rates of alcohol problems. Substantial excise tax increases would help alleviate both problems. While there would be costs in terms of higher prices and loss of jobs in the alcohol and related industries, these would be offset at least in part by higher tax revenues, reduced alcohol problems and associated costs to society, higher worker productivity, and some new jobs in other sectors of the economy.

As the first step in updating federal alcohol excise taxes, we recommend that the tax on distilled spirits, now set to be $12.50 per proof gallon beginning October 1, 1985, be doubled to $25 per proof gallon. The tax (in constant dollars) was at this rate or substantially higher between 1940 and 1972.

Our second recommendation is to tax all beverages equally on the basis of their alcohol content. Currently, liquor is taxed relatively heavily, table wine very lightly, and beer somewhere in between, probably reflecting traditional attitudes about spirits ("demon rum"). In reality, a can of beer, a glass of wine, and a small mixed drink all contain roughly the same amount of ethanol and pose roughly similar risks. There are beer alcoholics, wine alcoholics, and liquor alcoholics. The only justification for taxing hard liquor extra heavily is that, drunk straight, it is much more concentrated than beer or wine and can lead to faster inebriation. On the other hand, beer is the beverage of choice among youths. Acknowledging the impossibility of quantifying the relative hazards of different beverages, we conclude that all alcohol should be taxed at the same rate.

The projected effects on sales of doubling the current tax on liquor and then raising beer and wine taxes to the same level are shown in Table 7.

Table 7. Effects of Increased Beer, Wine, and Liquor Taxes*

	Change in Sales (gallons)	Change in Fed. Exc. Tax Revenues (billions)	(percent)
BEER	-12.2%	+$8.81	+581%
WINE			
Table	-20.5%	+$2.40	+2,613%
Fortified	-32.6%	+$.46	+905%
Nat. Carbonated	-4.2%	+$.12	+69%
ALL WINE	-20.6%	+2.98	+934%
LIQUOR	-12.0%	+3.91	+110%
TOTAL	-13.1%	$15.70	+291%

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* Doubling the liquor tax and then taxing beer and wine at the liquor rate (per unit of alcohol). The projected $15.7 billion in increased excise taxes would be partially offset by a loss of $3.93 billion in other tax revenues.

Under existing tax laws, malt beverages are all taxed at the same rate, regardless of alcohol content, while liquor products are taxed on the basis of their varying alcohol content. Wine is taxed at several rates, depending on alcohol content and carbonation. We note that basing tax rates solely on alcohol content would result in lower taxes on reduced alcohol beers and wines than for their traditional counterparts, just as lower proof distilled liquors are now taxed at a lower rate. This would serve as an incentive for consumers to choose lower-alcohol products.

The tax increases proposed amount to $1.32 for a six-pack of beer, $1.35 for a 750 ml bottle of wine, and $2.78 for a 750 ml bottle of 80 proof liquor (these estimates include a 20 percent mark-up on the tax increases). On a per-drink basis, these increases amount to 22 cents on a can of beer, 20 cents on 4 ounces of wine, and 17 cents on a 1.5 ounce shot of liquor.

If such tax increases were enacted, we project that they will yield some $12 billion a year in new revenues, an 14 percent decline in alcohol consumption, and a reduction in the costs to society of alcohol problems of roughly $16 billion a year. The new revenue would be more than the total amount of federal income taxes paid by the 23 million taxpayers whose adjusted gross incomes were under $12,000 in 1983.[29] Their tax payments totalled $10.68 billion.

The above projections are based on certain assumptions regarding the effects of tax increases on product prices and the effect of price increases on consumption. Projections for several other combinations of assumptions (-0.1, -0.35, -0.7 price elasticities; 0, 20, 40 percent mark-ups on taxes) are shown in Appendix II. For the lower elasticity, new tax revenues are estimated at about $13.5 - 13.7 billion; for the -0.7 elasticity, revenues are estimated at $8.4 - 10.1 billion.

Legislation should insure that inflation not diminish the value of alcohol taxes in the future as it has in the past. Taxes are not now keyed to inflation. As a result, the nominal $12.50 tax on liquor that was voted in 1984 will be worth only $12 by the time it goes into effect on October 1, 1985. In order that taxes keep pace with inflation and have a progressively greater effect in reducing alcohol problems, we urge that taxes be adjusted annually for inflation. In order to stabilize prices of alcoholic beverages in comparison to the standard of living, taxes should also be adjusted periodically for increases in per capita disposable income.

To maximize the benefits of higher excise taxes, especially to the people who will bear the greatest burden of taxation, a portion of the increased revenues should be earmarked for research, treatment, and prevention activities aimed at reducing the toll of alcohol problems. Another portion should be devoted to training and relocation programs to aid workers who lose their jobs as a result of lower rates of alcohol consumption. A third portion might be shared with states to make up for any lost tax revenues they would incur. Other important health programs could be supported by the remainder.

Officials of alcoholic beverage companies, at times, say that tax increases will cut sales and actually reduce tax revenues. At other times, they say that drinkers will continue to drink and that alcohol problems will not decline. Industry cannot have it both ways: either sales will go down and problems will diminish, or sales will not be affected and tax revenues will rise. It is most reasonable to predict that tax increases will both generate new revenue and reduce alcohol problems.

# # #

Footnotes

1. "Third Special Report to Congress;" Nat. Inst. on Alc. Abuse and Alcoholism (1978).
2. "The Effectiveness and Costs of Alcoholism Treatment," Office of Technology Assessment (1983); Research Triangle Institute report to ADAMHA (1983 costs to society due to alcohol abuse calculated at $116.674 billion).
3. "Fifth Special Report to Congress," p. xiii. Nat. Inst. on Alc. Abuse and Alcoholism (1983).
4. The National Institute on Alcohol Abuse and Alcoholism estimates that the cost to Medicare of inpatient and outpatient alcoholism treatment programs in 1981 totalled $155 million ($178 million in 1984 dollars). ("Report to the United States Congress on Federal Activities on Alcohol Abuse and Alcoholism, FY 1981/82", p. 76) DHHS acknowledges that this barely scratches the surface of alcohol-related costs, because it excludes treatment for cirrhosis, cancer, motor vehicle crashes, domestic violence, etc.
5. (a) direct expenses for federal programs: The costs of Medicare, Medicaid, veterans services, Indian Health Service, Department of Defense health programs, and health insurance premiums for federal employees are increased because of alcohol problems. The total cost to the federal government of these programs is $98.7 billion (1984 for Medicare and Medicaid; 1982 figures for other programs). The percentage of these costs related to alcohol can be calculated as follows. According to Health Care Financing Administration (HCFA), total U.S. health expenditures (FY 1984) were $355 billion; according to RTI [2], treatment and support costs for alcohol-related problems in 1983 were $14.865 billion, or $15.5 billion in 1984 dollars. Thus, alcohol is responsible for approximately 4.4 percent of all health care costs. Taking 4.4 percent of $98.7 billion, one can estimate that alcohol is responsible for $4.34 billion in costs to the various federal health programs. To that sum, one needs to add the $62 million budget of NIAAA, indicating a grand total of $4.4 billion.

   (b) productivity losses: RTI [2] estimates productivity losses (goods and services not produced) due to mortality at $18.151 in 1983 and to morbidity at $65.582. RTI (pers. comm., Richard Harwood, July, 1985) estimates further that 15 percent of these amounts are non-marketplace productivity (household services). Thus, marketplace productivity losses amount to $71.2 billion per year. Considering that the federal government employs 4.3 percent of the workforce, and assuming that federal employees have the same rate of drinking problems as other workers, the government's productivity losses due to morbidity and mortality amount to $3.1 billion per year.

   (c) tax losses: The federal government loses corporate income tax revenues due to alcohol-related productivity losses in the private sector. Assuming a marginal tax rate of 25 percent (the figure used by the Congressional Budget Office, pers. comm., Neil Fischer), the federal government loses out on the $18 billion a year in corporate income taxes that would have been paid on this income.

   The sum of these three types of direct and indirect costs and tax expenditures is approximately $25.5 billion per year.
6. "Historical Statistics of the United States; Colonial Times to 1970. Part 2" Series Y 358-373. Bureau of the Census (1976).
7. West, M.D., L.J., (ed), Alcoholism and related problems: Issues for the American Public, The American Assembly, Columbia University; p. 164. (1984); pers. comm., Dept. of Treasury press office.
8. Money not spent on products and services would mean lower taxable profits for the general economy. The Congressional Budget Office assumes that for every new dollar collected from excise taxes, other tax revenues would drop by $C.25. Thus, the $105 billion in additional revenues reflects the difference between $140 billion in higher excise tax revenues and $35 billion in lost corporate and individual tax revenues. Other figures in this paper reflect this net tax gain, except where otherwise indicated.
9. Most states have not been as reluctant to raise alcohol taxes as Congress has. In 1964, federal

tax revenues were more than twice as great as state revenues. In 1983, state revenues ($5.8 billion) out-stripped federal revenues ($5.65 billion). ("1983/1984 Public Revenue from Alcohol Beverages," Table 8, Distilled Spirits Council of the U.S.). Nevertheless, state excise taxes failed to keep pace with inflation: average taxes rose 147 percent between 1964 and 1983, but the consumer price index increased by 221 percent.

10. *Toward the Prevention of Alcohol Problems,* National Research Council, National Academy Press, Washington, D.C.; Chapter 3 (1984).
11. "Alcohol Policy in Sweden," Swedish Council for Information on Alcohol and Other Drugs. Stockholm (1982).
12. *Supra,* ref. 3, p. xxiii (1983).
13. Mosher, J.F. and Beauchamp, D.E., "Justifying Alcohol Taxes to Public Officials," *Journal of Public Health Policy* 4: 4 (1983); also see Bureau of Labor Statistics' consumer price indexes for alcoholic and non-alcoholic beverages.
14. Grossman, M., Coate, D., and Arluck, G.M., "Price Sensitivity of Alcoholic Beverages in the United States," Conference on "Control Issues in Alcohol Abuse Prevention II: Impacting Communities." Charleston, S.C. (September, 1984).
15. U.S. Dept. of Agric., *Food Consumption: Households in the U.S., Spring 1977;* Nationwide Food Consumption Survey, Human Nutrition Service, Consumer Nutrition Center.
16. "Excise Wars Winner$ and Lo$ers," Quarterly Beverage Alcohol Report, Beverage Management Resource Group, Falls Church, Va. (1983).
17. "The effect of liquor taxes on drinking, cirrhosis, and auto accidents," P. Cook, in *Alcohol and Public Policy: Beyond the Shadow of Prohibition,* National Research Council, National Academy Press, Washington, D.C. (1981).
18. Pers. Communication, S. Conly, Dept. of Treasury, June 1985.
19. Fact Sheets on Sweden, "Alcohol and Drug Abuse in Sweden," FS 77 j Ohi, The Swedish Institute, Stockholm (July, 1984).
20. DISCUS White Paper, Feb. 23, 1983; p. 12-13.
21. DISCUS paper, June 13, 1983.
22. Ornstein, S.I. "Control of Alcohol Consumption Through Price Increases." *J. Studies on Alcohol* 41 807-818 (1980).
23. Several estimates of price elasticity for cigarettes are: -0.42 (adults) [Lewit, E.M., Coate, D., "The Potential for Using Excise Taxes to Reduce Smoking." *J. Health Econ.* 1: 121-145 (1982)]; -1.4 (teen-agers) [Lewit, E.M., Coate, D., Grossman, M. "The Effects of Government Regulation on Teenage Smoking." *J. Law and Econ.* 24:545-569 (1981)]; -0.3 to -0.4 [Harris, J.E., "Increasing the Federal Excise Tax on Cigarettes," (unpublished paper) (Oct. 1981).
24. *Alcohol and Public Policy,* op. cit; Chapter 2.
25. Room, R., "Alcohol Control and Public Health," *Ann. Rev. Public Health* 5: 293 (1984).
26. *Lancet* ii 1175 (1980).
27. Fact Sheets on Sweden, "Facts and Figures about Youth in Sweden," FS 88 Ohfb, The Swedish Institute, Stockholm (December, 1983).
28. Quoted in *Alcohol in America,* Olson, S. National Research Council, National Academy Press, Washington, D.C. (1985) pp. 52-53.
29. Internal Revenue Service, *Statistics of Income Bulletin,* 4 30 (Winter 1984-85).

We gratefully acknowledge the advice and criticisms of numerous individuals who aided our journey into the murky world of economic forecasts, including Mark Albion, Philip Cook, Allen Ferguson, Eugene Lewit, Stanley Ornstein, John W. Richards, Jr., Isabel Sawhill, and Marvin Schneiderman. Needless to say, these individuals do not necessarily agree with some or all of the assumptions, conclusions, and recommendations that we have made.

# # #

APPENDIX I

The mathematical model for estimating the effects of tax increases on prices and consumption incorporated the following data:

(a) Fiscal year 1984 tax revenues and tax rates (Int. Rev. Serv.).

(b) 1984 sales of total alcoholic beverages (Dept. Commerce).

(c) Estimates of percentage of alcoholic beverage market divided between beer (54%), wine (13%), and liquor (33%) came from Distilled Spirits Council of the U.S. ("Annual Statistical Review 1983/84," Table 48; 1984 breakdown extrapolated from trend in recent years).

(d) Breakdown of wine market between table wine (less than 14% alcohol), fortified wine (14-21% alcohol), and naturally carbonated wine was based on tax revenues (Bureau of Alcohol, Tobacco and Firearms (BATF). (Minor tax categories and varieties of wine were ignored; 81% of wine accounted for in the 3 main tax categories was extrapolated to represent all wine sales).

(e) Domestic taxable wine production data from BATF; wine import gallonages from Census Bureau.

(f) Alcohol content for beer is 4.5% by volume, which averages light and regular beers; alcohol content for table wine, 11.6%, is a weighted average of standard wine and wine coolers (volumes obtained from BATF); alcohol content of wine in the 14-21% alcohol tax category is 20% (BATF); alcohol content of naturally carbonated wine is 12% (BATF).

(g) Average prices of beer ($3.80 per six-pack of 12-ounce cans), table wine ($2.31 per 1/5 gallon), fortified wine ($2.40 per 1/5 gallon), naturally carbonated wine ($5.20 per 1/5 gallon), and liquor ($10.17 per 1/5 gallon of 80 proof liquor) were based on total dollar sales divided by total gallonage sold (derived from tax revenues and knowledge of total dollar volume sold; this combines sales at restaurants, bars, supermarkets, liquor stores, and those made directly from wholesalers to businesses).

(h) Because most statistical data are based on gallons, our estimates were made for 1/5 gallon of wine and liquor rather than 750 milliliters, the current standard size bottle, but the difference is less than 3 percent (1/5 gallon = 726 ml).

(i) Consumer price indexes were obtained from the Bureau of Labor Statistics.

(j) "Costs related to alcohol consumption" were assumed to be proportional to alcohol consumption.

Appendix II

The figures in the body of the paper are based on a price elasticity of -0.35 and a 20 percent mark-up on taxes as products move through the distribution chain. The following table lists revenue increases and decreased costs to society that follow from different assumptions.

Assumptions		Increased Tax Revenues Revenues (gross) Billions of Dollars	Decreased Costs to Society Billions of Dollars
Elasticity	Mark-ups		
-0.1	0%	18.253	3.915
-0.1	20%	18.090	4.697
-0.1	40%	17.934	5.480
-0.35	0%	16.259	13.701
-0.35	20%	15.701	16.441
-0.35	40%	15.142	19.182
-0.7	0%	13.467	27.402
-0.7	20%	12.350	32.882
-0.7	40%	11.234	38.363

Dr. **Jacobson**. First of all, we strongly support equalizing of the tax rates on the different types of beverages. This would acknowledge that alcohol is alcohol is alcohol. Regardless of the beverage it comes in, it is the quantity of alcohol that poses the problem.

Raising the wine tax to equal the beer rate is a step in the right direction. We would urge the committee to go one step further and increase the beer and wine rates to the distilled spirits level. Doing so would raise $4.7 billion a year in new revenues and would reduce alcohol problems by about 5 percent.

In another scenario we looked at, equalizing for alcohol content and then doubling the tax rates would raise $12 billion a year and result in a 14-percent decline in alcohol problems.

In addition to raising rates, indexing taxes for inflation is key; because taxes have not been indexed for inflation over the past 30 years, the Treasury has lost out on about $75 billion in revenues.

There is remarkably broad support for raising alcoholic beverage taxes. A Roper poll found that 66 percent of the general public supports higher alcohol taxes. Moreover, dozens of prominent economists support higher alcohol taxes and the equalization of taxes based on alcohol content, partly to internalize the currently external costs of alcohol problems. Some of the economists include Alice Rivlin, Walter Heller, Joseph Pechman, Henry Aaron, and three Nobel Laureates.

Though raising the excise taxes has been criticized as being regressive, there are several important mitigating factors.

First, alcohol, unlike gasoline and the telephone, is hardly a necessity; but in fact, alcohol, like tobacco, is a harmful drug.

Second, low-income people actually drink significantly less than middle and upper income people. And perhaps most telling, numerous spokespersons for low income people endorse sharply higher excise taxes on alcohol. These include Coretta Scott King, Marian Wright Edelman and the Children's Defense Fund, and the American Association of Retired Persons. And of course, most of these persons would like to see the increased revenue be used to save social programs rather than to finance lower corporate taxes.

In conclusion, I would like to emphasize that raising and equalizing the tax rates is fair, it is supported by the general public and by respected economists, and would both raise billions of dollars in new revenue and reduce alcohol problems in this country.

Thank you very much, gentlemen.

[The written prepared statement of Dr. Jacobson follows:]

TESTIMONY

HEARING ON EXCISE TAXES

COMMITTEE ON FINANCE
UNITED STATES SENATE

MICHAEL F. JACOBSON, Ph.D.
Executive Director
Center for Science in the Public Interest
1501 16th Street, N.W.
Washington, D.C. 20036

APRIL 21, 1986

My name is Michael Jacobson. I am executive director of the Center for Science in the Public Interest (CSPI). The Center is a non-profit organization that advocates improved health and nutrition policies and healthy living practices. Currently, CSPI has over 70,000 members throughout the United States.

The Center coordinates the National Alcohol Tax Coalition (NATC), a group of some 30 national and 70 state and local organizations that is urging Congress to raise excise taxes on alcoholic beverages. This coalition, which includes such diverse groups as the American Association of Retired Persons, National Council on Alcoholism, Remove Intoxicated Drivers, and the National Association of Private Psychiatric Hospitals, specifically supports a position statement (a copy of which is attached) calling for the doubling of current excise tax rates on beer, wine, and hard liquor, and the equalization of tax rates, at the liquor rate, on the alcohol in those three beverages. On that point, my testimony today represents the views of NATC member groups as well as those of Center for Science in the Public Interest. A list of supporters of the Coalition's position on alcohol excise tax increases is attached to this testimony.

The social and economic costs of alcohol abuse in the United States are devastating. Government estimates put the yearly toll at between 100,000 and 200,000 lives lost and about $120 billion in economic harm. These statistics, however, don't begin to describe the widespread pain, suffering, and anguish that result from excessive drinking in America. While the tragedies of drunk driving are well-known, alcohol is also related to half or more of all drownings, child and wife abuse, rapes, and homicides. Alcohol affects practically every organ in the body and, in sufficient quantity, causes brain damage, liver cirrhosis, birth defects, heart disease, and cancers of the liver, mouth, throat, esophagus, and larynx. The harm alcohol causes in the form of broken families, ruined careers, and school failure is incalculable. The dollar costs include health care costs, reduced productivity, and social welfare programs, among other factors. It is no wonder that alcohol abuse is considered by many experts to be the number one drug problem in America.

At the same time, this nation is faced with staggering budget deficits which threaten our economic vitality. Gramm-Rudman deficit-reduction targets put the survival of important health care and social programs in jeopardy. This committee has an historic opportunity to address both of these problems simultaneously, and in so doing improve the economic and physical health of our nation.

Federal excise taxes on beer and wine were last increased in 1951. Taxes on liquor rose 19% last October, but still lag well beyond inflation since their previous increase during the Korean War. Adjusted for inflation, these taxes are lower than they have ever been since the end of Prohibition. Low tax rates have contributed to the declining relative price of alcoholic beverages, increased consumption, and increased alcohol problems. The failure of alcohol excise taxes to keep up with inflation has been a windfall for the alcoholic beverage industry. For the public health, it has been a disaster. For the U.S. Treasury, it has meant the loss of about $75 billion in additional revenue between 1952 and the present. Now is the time for major increases in alcohol excise taxes and major changes in the way beer, wine and liquor are taxed.

The proposal before this Committee calls, in part, for an increase in the tax on wine to the level at which alcohol in beer is taxed. We support equitable tax treatment for all alcoholic beverages. We believe that the Committee should extend this equalization concept to increase the taxes on both beer and wine to the level at which alcohol in liquor is taxed. There is no sound rationale for the continued preferential tax treatment of beer and wine. Low taxes on these beverages -- less than 3 cents a 12-oz can of beer, and less than 3 cents for a bottle of wine -- perpetuate the dangerous myth that beer and wine are somehow innocuous "beverages of moderation".

Today, the alcohol in liquor is taxed at about 4 times the rate of alcohol in beer and 17 times the rate of alcohol in wine. From both a public health and revenue perspective, this approach makes no sense at all. Let's face it, alcohol is alcohol is alcohol. In whatever form, it can be addictive and its abuse dangerous and life-threatening. Liquor may be the most concentrated form of alcohol, but for teenagers, who are at high risk of auto accidents and other violent episodes, beer is the favored beverage. Beer is the choice of most drivers who end up in fatal auto accidents. Low-income alcoholics choose fortified wine, the cheapest source of alcohol, and suffer as a result.

Economists at the National Bureau of Economic Research recently presented evidence that increases in beer taxes would be extremely effective in reducing auto accident fatalities among teenagers and young adults. Equalizing the rate of tax on beer to the rate of tax on alcohol in hard liquor would reduce accident deaths for 18-20 year-old males by 20%. Thousands of lives would be saved, on top of those being saved by increases in state drinking ages.

Taxing the alcohol in beer and wine at the hard liquor rate would yield significant new revenues and other beneficial results. Based on an econometric model developed by the National Alcohol Tax Coalition, we estimate that net revenues would increase by approximately $4.7 billion annually. On top of that, we estimate that alcohol consumption would drop by nearly 5%, and the economic costs to society saved due to reduced levels of alcohol problems would amount to almost $6 billion. The Tax Coalition's full proposal calls for doubling tax rates that have been equalized at the liquor rate. Such action would yield $12 billion in additional net revenue and reduce the costs of alcohol abuse by about $16 billion.

Federal excise taxes on beer and wine have been so low for so long, it is high time for substantial increases to bring these products out of the soft-drink price range. In order to avoid unnecessary economic dislocation and consumer resentment, these tax hikes could be implemented gradually, over a period of three or four years.

In addition to raising tax rates on wine and beer to equal the rate of tax on alcohol in hard liquor, taxes on all alcoholic beverages should either be indexed to inflation or set at an ad valorem rate (percentage of price at the producer level). Such a change, which is akin to a proposal before this Committee, would ensure that the relative price of alcoholic beverages in our economy remains stable, and would guarantee that the U.S. Treasury never again is robbed of billions in revenue because alcohol taxes were stuck at fixed levels during a time of high inflation.

This Committee has heard much about the regressive effect of excise taxes -- that taxes on alcoholic beverages would hurt low-income consumers most. Although low-income consumers pay a higher proportion of their disposable income than would a wealthy person for the same product, several factors distinguish taxes on alcoholic beverages from other excises, such as on gasoline or telephone service, and minimize any possible discriminatory effect on the poor.

First, alcoholic beverages are relative luxuries, discretionary items, not essentials like telephone service and transportation. Second, higher taxes on alcohol would hardly be felt by about two-thirds of the adult population. Thirty-six percent abstain and another third consume less than two drinks per week.

Among drinkers, upper-income households spend over twice as much on alcoholic beverages as lower-income households. Lower-income persons, about 25% of whom are elderly persons who consume the least alcohol of any adult cohort, spend only a small fraction -- around 2% -- of total consumption expenditures on alcohol.

A look at industry marketing data on alcoholic beverages, compiled by the Simmons Market Research Bureau, and reported in Impact magazine (September 1, 1985), is instructive in determining the alleged regressive impact of increases in excise taxes on alcohol. For the highest category of household income ($50,000 and over), 49.4% report consumption of beer and 64.3% report drinking wine. On the low end of the scale, only 30.2% of households under $10,000 income report drinking beer, and only 28.6% report drinking wine. Even for households with income between $20,000 and $24,999, only 45.6% report drinking beer and 44.3% report drinking wine.

Therefore, excise taxes on beer and wine, and any increases, will be paid predominantly by those outside of the lowest income brackets.*

Furthermore, according to the National Institute on Alcohol Abuse and Alcoholism, roughly 20% of drinkers consume 70% of all alcohol. Higher taxes -- and prices -- on alcoholic beverages would discourage excessive drinking among many in this relatively small fraction of all adults. Additionally, those who continued to drink heavily would be required to contribute more equitably to offset the costs of alcohol abuse to society.

Higher taxes on alcoholic beverages -- particularly equalization of tax rates on beer, wine and hard liquor -- can generate substantial new revenues, reduce alcohol problems and costs, and help educate Americans about the proper role of alcohol in our society. These new revenues should provide a source of funds to insure that vital domestic health care and social programs -- many of which are involved in either preventing, researching, or treating alcohol problems -- are not sacrificed on the cross of the Gramm-Rudman deficit reduction act. Higher alcohol taxes should be used to assure that proposed tax legislation results in increased revenue capable of offsetting budget deficits.

The health of America demands that Congressional budget and tax action preserve and strengthen programs to promote health and combat alcohol abuse and alcoholism. The Public Health Service's National Institute on Alcohol Abuse and Alcoholism should be singled out to receive adequate funding and support.

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* Another study, conducted by National Family Opinion (NFO), Inc., and reported in Impact magazine (July 15, 1985), bolsters the view that alcohol taxes do not hit low-income persons hardest. Households with income under $15,000 (with a 25.4% income share) consumed only 10.6% of all wine and 20.8% of malt beverages. In contrast, households with income of $35,000 and over, with a 26.4% income share, consumed 41.3% of all wine and 25.2% of malt beverages. According to the NFO study, households with income less than $25,000, with a 50.3% income share, consumed 26.5% of all wine and 46.8% of malt beverages. Households with incomes of $30,000 and over, with a 35.6% income share, consumed 57.8% of all wine and 37.6% of malt beverages.

Recent polls demonstrate that a large majority of the American public supports higher taxes on alcoholic beverages. An August, 1984 Roper survey for the Christopher D. Smithers Foundation found that 77% of leadership persons surveyed (corporate executives, federal legislators and state governors, religious leaders, educators, physicians, and the military command) approve of doubling the tax on alcoholic beverages to combat alcoholism. Some 66% of the general public also support doubling the tax.

Perhaps more significantly, some 80 prominent economists, including 3 Nobel laureates, recently joined in a petition to Congress urging that taxes on alcoholic beverages be raised substantially, both to improve the public health and reduce budget deficits. These economists specifically called for the elimination of differential tax treatment for beer, wine, and liquor.

The time has come for Congress to get in step with the public and sound economic policy. Thirty-five years of inaction on alcohol excise taxes must be remedied. For starters, raise beer and wine taxes now.

ATTACHMENT 1

IMPACT OF ALCOHOL EXCISE TAX INCREASES ON FEDERAL REVENUES, ALCOHOL CONSUMPTION, AND ALCOHOL PROBLEMS

by

National Alcohol Tax Coalition
1501 16th St. NW
Washington, DC 20036
(202) 332-9110

September 16, 1985

ATTACHMENT 1

SUMMARY

Federal excise taxes on alcoholic beverages have not been increased since 1951. Consequently, the taxes (adjusted for inflation) are lower than they have ever been since the end of Prohibition. The low tax rates have contributed to declining relative prices, and hence increased consumption ... and increased alcohol problems. Had excise taxes been adjusted regularly for inflation, the federal government would have received several tens of billions of additional tax dollars between 1952 and 1984.

Raising excise taxes would reduce both budget deficits and alcohol problems. Tax increases would likely have an especially great effect on reducing alcohol consumption by youths.

A model was developed to estimate the effects of various tax increases. Of the five different plans considered, a doubling of the excise tax, which would still not bring the taxes up to pre-inflation levels, was found to have the least effect on revenues, sales, and problems: $4.3 billion in new revenue per year and a 5.2 percent decline in alcohol consumption. The reduced drinking would reduce alcohol problems by about $6 billion annually. The greatest impact would come from raising the tax on liquor to make up for inflation since 1951 and then raising the relatively low taxes on beer and wine to equal the rate per unit of alcohol in hard liquor. This adjustment would yield $20.5 billion in net revenue and result in a 30.2 percent decrease in consumption and a decrease in alcohol problems estimated to save about $36 billion.

After considering historical tax rates and the effects of tax increases, several recommendations are made. First, the tax on hard liquor should be doubled, returning it to its 1972 level (adjusting for inflation). Then the taxes on beer and wine should be raised so that these beverages are taxed at the same rate per unit of alcohol as liquor. To prevent these taxes -- and prices -- from being eroded by future inflation, alcohol taxes should be adjusted annually to keep pace with disposable income and inflation. These adjustments would generate approximately $12 billion annually in new revenues and reduce alcohol consumption by 14 percent. The decline in drinking would reduce direct and indirect costs of alcohol problems by about $16.4 billion. Using different assumptions about the relative elasticity of demand for alcoholic beverages, the increased tax revenues would vary between $8.4 billion and $13.7 billion; decline in consumption, 3.2 to 32 percent; reduction in alcohol problems, $4 billion to $38 billion. Finally, portions of the revenue should be earmarked for alcohol education and treatment programs, training programs for dislocated workers, and aid to states.

NOTE: FULL COPIES OF THE REPORT ARE AVAILABLE FROM CENTER FOR SCIENCE IN THE PUBLIC INTEREST, $3.00 PER COPY.

ATTACHMENT 2

NATIONAL ALCOHOL TAX COALITION
STATEMENT ON ALCOHOL EXCISE TAXES

The National Alcohol Tax Coalition is comprised of diverse national, state, and local groups that support a substantial increase in federal excise taxes on alcoholic beverages. Increased taxes will serve two purposes: they will help reduce the enormous cost of health and social problems related to alcohol abuse by discouraging excessive alcohol consumption and they will enrich the U.S. Treasury by billions of dollars. This extra revenue will lessen the deficit-driven need to further decimate vital domestic social programs. In addition, new revenues can help expand funding for alcohol abuse prevention, treatment, and research, as well as provide increased stability for public health care programs such as Medicare.

The economic costs of alcoholism and problems related to alcohol abuse are staggering. According to government-sponsored studies and reports, alcohol-related problems cost society approximately $120 billion and 100,000 - 200,000 deaths each year, plus untold amounts of human grief and suffering. The catastrophic damage linked to drinking includes:

- 53% of all traffic fatalities;
- as many as 60% of child and spouse abuse cases;
- industrial and recreation accidents;
- over 50% of violent crimes, suicides, fatal fires, and drownings;
- birth defects, spontaneous abortions, and liver damage;
- rising incidence of teenage drinking; and
- alcohol dependence for nearly 13 million Americans.

Until Congress recently authorized an increase in taxes on distilled spirits, federal alcohol excise taxes had not been raised in thirty-four years; the rates for beer and wine still remain at their 1951 levels. The failure to raise federal excise tax rates has resulted in a steady decrease in the tax rate and tax revenues in terms of real dollars. The failure to index federal excise taxes to inflation has resulted in a loss of billions of dollars of revenue. While Congress scrambles to find ways to lessen the burgeoning budget deficit, the possibility of additional alcohol tax hikes remains a viable — and increasingly inviting — political option.

We urge the President and Congress to join the majority of Americans who recognize alcohol abuse as a major national problem and who support higher federal alcohol taxes on alcohol beverages as a means of improving our nation's social and economic health. As a start, we offer the following suggestions: restore the tax on hard liquor to its 1974 level, raise taxes on beer and wine so that these beverages are taxed at the same rate per unit of alcohol as liquor, and to prevent these taxes — and prices — from being eroded by inflation, adjust alcohol taxes annually for increased inflation and disposable income. Finally, a portion of these revenues should be allocated to help reduce alcohol problems and expand access to health care services. These measures might be implemented on an incremental basis to avoid sudden economic dislocation and consumer resentment.

Increasing alcohol taxes alone will not independently solve America's alcohol problems or budget deficits, but we believe that this measure is one important step in that direction.

Coordinator: Center for Science in the Public Interest 1501 SIXTEENTH STREET, N.W. WASHINGTON, DC 20036 (202)332-9110

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ATTACHMENT 3

NATIONAL ALCOHOL TAX COALITION
NATIONAL SUPPORTERS

Adventist Health Network
American Association of Retired Persons
American College of Preventive Medicine
American Council for Drug Education
American Council on Alcohol Problems, Inc.
American Licensed Practical Nurses Association
American Medical Students Association
American Youth Work Center
Association of Schools of Public Health
Center for Science in the Public Interest
Children's Defense Fund
The Children's Foundation
Citizens for Highway Safety
Consumer Affairs Committee of Americans for Democratic Action
Doctors Ought to Care
National Association for Public Health Policy - Council on Alcohol Policy
National Association of Alcoholism & Drug Abuse Counselors
National Association of Private Psychiatric Hospitals
National Center for Drunk Driving Control
National Council on Alcoholism
National Council on the Aging, Inc.
National Drivers Association for the Prevention of Traffic Accidents, Inc.
National Women's Christian Temperance Union
National Women's Health Network
Public Citizen
Remove Intoxicated Drivers

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NATIONAL ALCOHOL TAX COALITION
FACTS ABOUT FEDERAL ALCOHOL EXCISE TAXES

ATTACHMENT 4

- Until a 19% increase in liquor taxes (not on beer and wine) effective October 1, 1985, federal excises on alcoholic beverages had not been increased since 1951.

- Beer and wine taxes are less than one-fourth of what they were at the repeal of Prohibition; the tax on liquor is about 25% less (figures expressed in constant dollars).

- Taxes on alcohol provided over 5% of federal domestic revenues in 1951. By 1984, the percentage dropped to 0.8%. Alcohol revenues were $5.4 billion in 1984.

- Due to inflation since 1951, the real dollar value of tax revenues on alcoholic beverages declined by 75%. Inflation during this period cost the Treasury between $40 and $75 billion in lost revenues.

- The current tax on a 12-ounce can of beer is 2.7 cents; on a glass of wine, about 0.5 cent; and on a shot of 80-proof liquor, 10 cents. The alcohol in liquor is taxed at about 4 times the rate of alcohol in beer, and about 17 times the alcohol in table wine.

- Government reports estimate the annual toll from alcohol abuse at between 100,000 and 200,000 deaths and $120 billion in economic damage.

- Higher alcohol taxes will reduce drinking by young people and heavy drinkers, and will reduce alcohol-abuser problems like fatal auto crashes and cirrhosis of the liver, according to economists at Duke University and the National Bureau of Economic Research.

- Doubling liquor taxes and then equalizing the rate of tax on alcohol in liquor, beer, and wine, as proposed by the National Alcohol Tax Coalition would:
  a) increase the tax on individual drinks of beer and wine by about 20 cents and on liquor, by about 10 cents; and
  b) provide approximately $12 billion in additional federal revenues, decrease alcohol consumption by about 14 percent, and reduce the annual economic costs of alcohol by up to $16 billion.

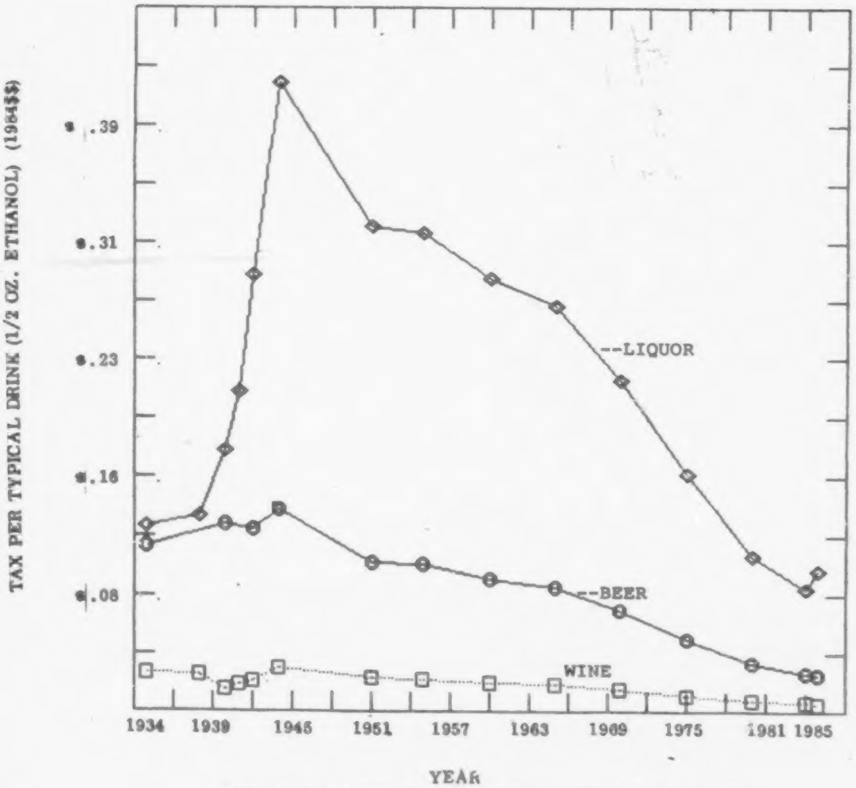
- The thirty-six percent of American adults who do not drink would pay no additional taxes; another third would pay less than 50 cents per week more.

- The $12 billion in additional revenues is more than the total taxes paid by the 23 million taxpayers whose adjusted gross incomes were under $12,000 in 1983.

- Twelve billion dollars would pay the combined annual costs of the National Institute on Alcohol Abuse and Alcoholism, the Administration on Aging, the juvenile justice and child abuse state grant programs, and the federal food stamp program.

NATC, 9/18/85

ATTACHMENT 5



RELATIVE TAXES ON BEER, WINE LIQUOR (1934 - 1985)

ATTACHMENT 6

CSPI CENTER
FOR SCIENCE
IN THE
PUBLIC INTEREST

ARE ALCOHOL EXCISE TAXES REALLY THAT REGRESSIVE?

Although an excise tax is regressive in nature, and falls most heavily upon those with the least ability to pay, several features of the alcohol excise tax minimize the negative impact on low-income people:

- Alcohol is a luxury, discretionary item, not a necessity. Increasing taxes on alcohol is fairer than increasing taxes on gasoline or on phone service. It is certainly more equitable than decreasing taxes primarily for upper income people (as was done in 1981).

- One-third of the population abstains; one-third drinks, on the average, little more than a drink per week. Low-income persons have the highest rate of abstinence, principally because the elderly, 25% of whom live in or near poverty, have the lowest drinking rate of any adult age group.

- Twenty per cent (20%) of the drinkers consume 70% of the alcohol. Therefore, heavy users would rightfully pay most of the tax, a portion of which would be used for programs to combat alcohol abuse.

- Upper-income households spend over twice as much on alcohol as lower-income households. A 1977 USDA Survey reported alcohol expenditures of $2.82 per week for households with over $20,000 income and spending of $.76 and $.89, respectively, for households with incomes under $5,000 and between $5,000 and $9,999. Well-to-do households will pay substantially more in taxes than the poor and help support programs to reduce the harm caused by alcoholism and alcohol abuse.

- Expenditures for alcohol represent only a small fraction of any income group's total consumption expenditures, around 2% for the tenth of the population with the lowest income.

- Dedication of funds for public alcohol abuse prevention and treatment programs would benefit the poor. Also, the availability of funds to offset budget deficits would save otherwise vulnerable public programs which provide vital services or assistance to low-income persons. These benefits outweigh the minimal additional cost to most low-income consumers.

- Doubling the excise tax would add about 3¢ to the price of a can of beer or a bottle of table wine. A consumer of a six-pack of beer a week would pay less than a quarter more. An across-the-board doubling of taxes would generate as much as $5.7 billion in additional revenues.

- A majority of Americans support a rise in the federal excise tax on alcoholic beverages. In a 1981 AP poll, 55% of those polled said that federal excise taxes should be raised, while 41% said they should not. Of those who favored a tax increase, 11% said taxes should be increased to raise revenue; 9% to discourage drinking; and 35% favored both.

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EXECUTIVE DIRECTOR: MICHAEL F. JACOBSON, Ph.D.

ATTACHMENT 7

ECONOMISTS' PETITION TO INCREASE FEDERAL ALCOHOL EXCISE TAXES

We, the undersigned economists, believe that the public health costs and other external costs associated with the consumption of alcoholic beverages are so significant as to justify substantial excise taxes on those beverages. In light of the fact that, in real terms, existing taxes have declined dramatically in the past thirty years and those on wine and beer were not increased even in nominal terms between 1951 and 1985, existing tax rates should be increased.

Further, we see no justification for the differential between the excise tax, per unit of alcoholic content, on beer and wine, on the one hand, and hard liquor on the other. Indeed, in light of the fact that beer is the standard introduction to alcohol for youth, favored tax treatment for it appears to be socially highly undesirable.

Finally, an increase in the excise tax on alcoholic beverages would contribute to the reduction in the budget deficit in a way that has no significant adverse economic effects and would have substantial social benefits, while tending to increase economic efficiency.

Consequently, we support efforts by the NATIONAL ALCOHOL TAX COALITION to increase federal excise taxes on alcoholic beverages and eliminate or modify the differential tax treatment between beer, wine, and liquor.

SIGNERS*

Henry J. Aaron, Senior Fellow, The Brookings Institution, Washington, DC
Mark S. Albion, Assistant Professor, Harvard Business School, Boston, MA
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Michael Grossman, Professor, City University of New York, New York, NY
Eric Hanushek, Professor, University of Rochester, Rochester, NY

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ATTACHMENT 7

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Sar A. Levitan, Director, Center for Social Policy Studies, The George Washington University, Washington, DC
S.M. Miller, Professor, Boston University, Boston, MA
Joseph J. Minarek, Senior Research Associate, Urban Institute, Washington, DC
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** Nobel laureate

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The CHAIRMAN. Thank you, Doctor.

Mr. Meister, there is a crosscurrent in the testimony—beer, wine, hard liquor—that beer is the working person's drink; wine you have normally with meals; hard liquor, apparently you sit on a bar stool and drink allegedly some degree of straight shots. Is there a distinction? Do you make this distinction in your mind?

Mr. MEISTER. No; it is a myth that there is a distinction. First, the restaurant groups who have done studies on this show that a mixed drink is the drink of preference during meal times. The idea of somebody just sitting down and belting a shot is an inaccurate one. The people who drink our products use them in moderation; they are almost always in a mixed group.

As far as the income differential, we have commissioned studies and our companies have that really show there is very little differentiation by income level, whether you are drinking beer, wine, or liquor. Indeed, most consumers drink all three at different times and under different circumstances.

It is also disturbing to hear that for the 80 to 100 million Americans who drink our products responsibly, that we can simply say they can do without it. We can do without a lot of consumer products. But it is a product that is in most cases used moderately, and we have a right to sell the product, and the consumer has the right to buy it in a marketplace.

The CHAIRMAN. Dr. Jacobson, do you agree with the distinction that is made, or don't you agree that beer is the working person's drink, wine goes with meals, and hard liquor is apparently belted down?

Dr. JACOBSON. No. I think those are myths that have been propagated in our society. One could point to winos on skid row and say, "Wine is really the problem; it is the cheapest source of alcohol." Others could point to teenagers among whom beer is the drink of choice, "Beer is the entry-level alcoholic beverage; that's what people start on, and special attention should be placed there." Others say, "Well, hard liquor is the most concentrated form of alcohol, so you should focus on that."

The National Council on Alcoholism and most organizations concerned about alcohol problems come to the conclusion that, while there may be some distinctions, in general alcohol is alcohol is alcohol, and alcoholic beverages should be taxed on the amount of alcohol they contain.

The CHAIRMAN. Mr. Meister, in your testimony you note that liquor is taxed 4 times higher than beer and 16 times higher than wine. Why do you think that is? Why the distinction?

Mr. MEISTER. I think it was a historical distinction, going back many years ago probably to the Colonial days, when rum in particular was taxed. There is no public policy basis or scientific basis to have that differential, and certainly at the rates that exist at this point in time.

The CHAIRMAN. I am curious. I notice again in your statement that you say that in this country over 50 percent of wine sales are accounted for by 5 companies, and two-thirds by 10 companies, and that 3 companies produce two-thirds of the domestic beer sold in the United States. Do you have that kind of concentration in the hard liquor industry?

Mr. MEISTER. Basically, 10 to 12 distillers do produce most of the liquor that is sold in the United States. That is correct. But the point is that we are all mature industries. Wine is as mature an industry as is liquor, and the discrimination that liquor has is not justified on that basis.

The CHAIRMAN. Do you support taxing alcoholic beverages on an alcohol-content basis?

Mr. MEISTER. The only thing I can answer that with, Senator, is that liquor clearly cannot take another hit. We were singled out in October 1, 1985, for a 19-percent increase; our sales have been down in each of the last 5 years. As a result of the October 1 increase, the sales for the last quarter of 1985, where traditionally we sell 35 percent of our product, our sales in the Senate Finance Committee States were down 13.5 percent. Nationwide they were down 9 to 12 percent, and they continue to be down in 1986.

Additionally, we have had 63 tax increases at the State level just in the decade of the eighties, and the States represented on this committee, all but 5 have increased taxes in the past few years; so we cannot take any more.

The CHAIRMAN. That is not a responsive answer. Should we tax alcoholic beverages on an alcoholic-content basis?

Mr. MEISTER. If you have to come to the area of excise taxes, there has to be some redistribution of the discriminatory treatment liquor has. We would prefer and think it is better public policy to get away from excise taxes in total.

The CHAIRMAN. Why would fixing excise taxes based on price be so difficult? We do it now with telephones and airline tickets, and somehow both of those industries seem to manage it. My hunch would be that there are infinitely more small telephone companies in this country than there are at least small beer breweries or hard liquor distillers. to manage it.

Mr. MEISTER. Ours is primarily an industry that distributes the products—be it beer, wine, or liquor—through very small business establishments. The sales that they have have gone down substantially already. The proposals before this committee could decrease those sales as much as 10 to 15 percent and drive them out of business. So, I think whether you index or whether you do it directly, you are really talking about a substantial demise of employment in this industry.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

I want to state again that my position on increase in excise taxes is that, if increased, they should all go toward reducing the deficit.

So, my line of questioning will be with that premise in mind.

I would like to ask Mr. Debevc: What you said about the wine industry and the difficulties and the decline in the harvest of grapes seemed to be a bit contrary to the expansion of the industry as I understand it. Am I mistaken?

Mr. DEBEVC. Yes, your are. There is a tremendous amount of expansion coming from overseas.

Senator CHAFEE. No, no. I meant, for instance, I personally have witnessed in the Sonoma Valley in California individuals just last year creating new vineyards at their own expense. You might say they were recreational winegrowers if you want; it probably wasn't their principal source of income, but nonetheless they were doing it.

Mr. **Debevc**. Not quite like I am. The problem with that is that that is only about 2 percent of the total sales in this country. That is a very Hollywood approach to the wine industry, up in the Napa Valley north regions up there. It is not typical of what is happening across the country, especially in the southern areas of California where the bulk of the product is produced.

I think there is some expansion, but much of that expansion is done by people from Hollywood, people out of the country, a lot of foreign investment, and people from other industries that are trying to shelter some of their tax liability. It is not indicative of an operation like myself or other wineries like me.

We are trying to make a living farming. We are grapegrowers. We have been grapegrowers for years. However, there has been a great loss in the availability of making a profit in raising grapes for juice, jams, or jellies, or for that matter in the case of raisins. And wine in the 1970's had a resurgence, an interest because of the health ratifications of it. More people were interested in wine than other products, and there was a tremendous amount of growth.

But since the early 1980's, there has not been any significant growth. As a matter of fact, there has been a considerable amount of decline.

Senator **Chafee**. There hasn't been any growth in wine consumption? How about coolers?

Mr. **Debevc**. All right. There has been growth in coolers; however, table wine consumption outside of California, which would include our State of Ohio, is down 11.1 percent just in the last year. The only reason that there is shown any moderation in the decline is because of the coolers, being a new product, jumping into the market place.

However, from a grapegrower's aspect, that uses a very small percentage of grapes in that product; it is only 50 percent wine, and it is usually wine at the very low end of the scale in quality.

Senator **Chafee**. Could you once again give me the arguments on the chairman's proposal? You were against it, but what he is saying basically, as I understand it, is that the winegrowers should be taxed on the basis of alcoholic content like the distillers are.

Mr. **Debevc**. Well, that is setting a very bad precedent. There is no other country in the world that has that type of program.

Senator **Chafee**. No, he is saying like the beer is.

Now, I think Mr. Meister recited the tradition of distilled spirits being taxed more since the original founding days of the Republic; but what about beer and wine being taxed based on the alcoholic content?

Mr. **Debevc**. Well, first off, sir, table wine is now presently taxed three times the rate that beer is, at the present time. And we don't consider that——

Senator **Chafee**. Well, now, wait a minute, I'm not sure. Is that a fact?

Mr. **Debevc**. On liquid content, that is true.

Senator **Chafee**. I don't mean liquid content; I mean alcoholic content.

Mr. **Debevc**. Well, if you relate it to alcoholic content. But in no other country in the world is wine considered by its alcohol content. I think you set such a bad precedent. The only reason that the alcohol is in there is to naturally preserve the product; that is the reason for the product, and it is indicated by the consumers' preference to look toward lower alcohol products. That is why the coolers had some positive response and also many of the lower alcohol wines.

Senator **Chafee**. I am trying to get information.

Mr. **Debevc**. We don't add that alcohol to there, sir; that is a natural phenomenon of fermentation. Grapes come in at around 21 to 22 bricks, and they ferment down into the 12 percent range of alcohol. Farmers don't go around buying alcohol from distilleries to add to their grape juice so they can preserve it. That is just a natural phenomenon of wine.

Senator **Chafee**. As I understand the proposal, since coolers have a very low alcoholic content, the tax on a cooler, on a gallon of cooler, would be very, very modest.

Mr. **Debevc**. That is a manufactured product. That is like making cookies. We don't make cookies in our cellar; we take grapes, and bring those grapes in, and press them out and allow them to ferment in the tans or the vats, and make table wine. That is the traditional method that they made back when Jesus Christ was around.

What you are asking us to do is to remove the alcohol out of our product so we won't be taxed as high. You know, there is no method for us as grapegrowers to preserve our grapes. Grapes are harvested and have to be processed and sold within 10 days. From a grapegrower's aspect, that puts you at a definite disadvantage in selling that product. In other words the processor comes along and knows that from the beginning, that you are going to have to bring those grapes to his processing plant at the price he is willing to pay, no matter what.

We are not like the grain people, that we can put it in storage for 2 or 3 years until the prices come up; this is the only alternative that our grapegrowers have had to show a profit, to stay in the business.

Senator **Chafee**. Thank you.

The **Chairman**. I have been asked what the plans are. Clearly, we are not going to get through the entire panels today. So, when this panel is done I am going to take Senator Eagleton, who has come in. Then we will break for about 45 minutes, depending upon what time we finish, and come back after a 45-minute break.

Senator Pryor, questions.

Senator **Pryor**. No questions, Mr. Chairman.

The **Chairman**. Senator Mitchell.

Senator **Mitchell**. I would like to ask each of the witnesses to comment on that portion of the chairman's proposal which would relate taxation to price of product, that is, make it an ad valorem tax, whether you are for that or against that, and briefly why.

Mr. **Meister**. From the distilled spirits, we are strongly opposed to any indexing of the price. We are already the most heavily taxed consumer product. We are heavily taxed even within the beverage alcohol field, and we think it is punitive to single out one or two industries for indexing.

Also, there is an implication in indexing that we are not keepiog up with the inflation rates. If you talk about the Federal Government, that may be true, but remember in our business the States are substantial excise revenue raisers, to the tune of $3.3 billion in spirits. So, our total combined tax burden is really approximate to that which it was in previous years and has kept up with inflation.

Senator MITCHELL. Mr. Meister, basing the tax on the price of the product—not identical with indexing.

Mr. MEISTER. The administration this morning, Senator, mentioned indexing to the Consumer Price Index, which would be very different.

Senator MITCHELL. I am not mentioning indexing.

Mr. MEISTER. All right.

Senator MITCHELL. I am asking you whether you favor or oppose, instead of basing the tax on the volume of the product, on the price of the product. When you go to pay an excise tax on your automobile, the amount of the tax that you pay increases as the value of the automobile increases, and it decreases as the value decreases. You are aware of that?

Mr. MEISTER. Yes.

Senator MITCHELL. Do you favor or oppose doing that with alcohol-related products, and, if so, why?

Mr. MEISTER. We oppose indexing of any type on alcohol beverage products.

Senator MITCHELL. But you are not answering the question I am asking you; that is not indexing. That is saying if the price of a product is $10, therefore the tax is one level. If the price were $9, it would be at a lower level.

Mr. MEISTER. We think, if we had to go that way, that is a more equitable system than the current system, Senator.

Senator MITCHELL. So, you favor that?

Mr. MEISTER. Yes; if that was the case.

Senator MITCHELL. Thank you.

Mr. Busch.

Mr. BUSCH. We do not favor any price or tax increase on the beverage beer to the American working man and woman, Senator, whether it be in the form of the deductibility issue, whether it be in the form of a direct excise tax increase, or whether it be in the form of a price-related ad valorem tax.

I would like to clear up one more thing that has been said here throughout the morning.

Senator MITCHELL. Wait a minute, Mr. Busch. Now, that assumes that changing the basis of taxation, quantity to value—that is, making that an ad valorem tax—would result in a tax increase. That is not necessarily the case, of course. That would depend upon the amount of tax imposed once it was made ad valorem. I am asking you about the principle of ad valorem as a basis of taxation of alcohol-related products.

Mr. BUSCH. We are against any tax, ad valorem or otherwise, that would increase the price to the American working man and woman.

Senator MITCHELL. Well, what if an ad valorem tax reduced the tax? Would you favor it?

Mr. BUSCH. If the American working man and woman can purchase the product, beer, at a lower price, we would favor it.

Senator MITCHELL. So, you are not against the principle? All you are saying is, anything that results in an increase in taxes you are against, and anything that results in a decrease in taxes you are for? Is that fair? It doesn't make you unusual, Mr. Busch; it makes you like everybody else in America. [Laughter.]

Mr. BUSCH. If I have to answer it that way, Senator, I will say it is fair, in our favor.

Senator MITCHELL. I am not trying to get you to say something that marks you as different from others.

Yes, Mr. Debevc.

Mr. DEBEVC. I think the response to the end of that is, in our operation when money gets tight in our family, we tighten our belt. All right? And I think that is one of the problems that we have here.

Sure, nobody likes to see taxes increased, and everybody likes to see them decreased.

Senator MITCHELL. Right.

Mr. DEBEVC. When it comes to push and shove, my dad says, "Well, you just don't buy that equipment; you'll have to do without it." Or, "You don't buy a new car; you are going to have to drive the old clunker and fix it tonight, that's all."

I mean, I don't see why the Federal Government should be any different than my business: When you don't have the money, you tighten your belt. I don't see why we are giving away billions and billions of dollars to one industry, and then take it from an industry that is already faltering, an industry that has a tremendous amount of import problems. Import products are coming in that are scandalous.

Senator MITCHELL. I am reluctant to interrupt you, but that has nothing to do with the question I have asked you. [laughter.]

Could you respond to the question?

Mr. DEBEVC. If I had to take a tax, I would take a tax on the price—indexing to the price—simply because if I raise the price, then a percentage of that would come out in increased taxes. But I am totally against tying it to alcohol content.

Senator MITCHELL. Your answer is, Yes?

Mr. DEBEVC. On price indexing?

Senator MITCHELL. Yes.

Mr. DEBEVC. Yes.

Senator MITCHELL. Thank you.

Dr. Jacobson.

Dr. JACOBSON. Well, we have taken a position in favor of equalizing taxes based on alcohol content. We haven't made any calculations as to how the prices correlate with alcohol content.

Senator MITCHELL. So, your answer is "no answer," you haven't made any decision?

Dr. JACOBSON. We haven't made any calculations. I have not seen any figures on that.

Senator MITCHELL. My time is up. Would you review that and submit to this committee your response to that question, whether you favor or oppose changing the basis of taxation to ad valorem, and your reasons for being for or against it, Dr. Jacobson?

Dr. Jacobson. If we can get the figures, certainly.

Senator Mitchell. Well, you don't need any figures to understand the principle.

Dr. Jacobson. We wouldn't oppose the principle if it was consistent with an equality of rates. If it results in beer being taxed at 10 times the rate per unit alcohol of liquor, then we would be opposed to it.

Senator Mitchell. All right.

Thank you, Mr. Chairman.

[The reply follows:]

Reply to Senator Mitchell's Question, Regarding the Desirability of an Ad Valorem Taxation of Alcoholic Beverages

Unless an ad valorem tax were part of an alcohol tax overhaul that also taxed alcohol, in whatever beverage form, at an equivalent rate, we would be opposed. As a matter of policy, we believe that beverages should be taxed on the basis of their alcohol content. This would have public health ramifications that I noted in my testimony. There is no reason that the alcohol in Brand X, 80-proof liquor, which is priced at $5.00, should be taxed less than the same alcohol in a premium brand that sells at twice the price. It's the same thing, and whether consumed in the expensive or cheap version, the results, sometimes costly to the individual and to society, will be the same.

The Chairman. Senator Danforth.

Senator Danforth. I think all of you agree that if we were to increase the excise tax on beer, wine, and liquor, that would reduce the use of beer, wine, and liquor. Isn't that right? Isn't that a common thread that has run through everybody's testimony?

Mr. Meister. That is correct.

Senator Danforth. That, in fact, Dr. Jacobson, is why you favor increasing——

Mr. Debevc. If you are asking for opinions, before you assume everybody is going to agree.

Senator Danforth. I would like real short opinions, because I have three questions I want to ask.

Mr. Debevc. You know, you can relate it to other drug abuse problems. I don't think that just because we are concerned with the people who are alcoholics or the people who are on drugs. A price increase is not going to cause them to stop using it.

Senator Danforth. You disagree. But the other three agree that there would be a reduction of use of alcoholic beverages if we increase the excise taxes, right?

Mr. Meister. That is correct.

Senator Danforth. I think, then, what we are being asked to do is to legislate the reduction of alcohol use, and I think we have been through that before.

Let me ask you, Mr. Busch, is this the first time that State, local and Federal excise taxes on beer have been increased in the last, say, 35 years? Or has there been something of a history of increasing excise taxes at all levels of government on your product?

Mr. Busch. If you go back to 1951, which is the timeframe we are talking about, to the imposition of the taxes, the increases in taxes on beer came about, you are talking about a 560-percent increase in the tax revenues for excise taxes that have come about since 1951 until today.

They are not, Senator, as you well know, Federal; they are State and they are local, and they are almost across the board. So, we have had a 560-percent increase.

Senator **Danforth**. To the extent that we increase excise taxes on alcoholic beverages, does that tend to compete with a source of State and local tax revenue?

Mr. **Meister**. Absolutely. We estimate just for liquor alone, Senator, that the States would lose $140 million under this proposal. Indeed, there are several States who have written to us in the past few days indicating their opposition to it. I would like to quote just one letter.

Senator **Danforth**. I wish you wouldn't. Could you just put it in the record?

Mr. **Meister**. If we could put it in the record, then.

But, yes, it is a very strong degradation of State revenues.

Senator **Danforth**. I just want to make one assertion, and then I am through: I think that if there were to be a poll of parents of teenage kids as to whether or not beer and wine and hard liquor are all the same, the overwhelming opinion would be, "No, they are not all the same." I think there are an awful lot of parents who would say to a 17-year-old daughter, "Would you like a beer, or would you like a glass of wine?" who would never say, "Would you like a shot of Jim Beam?"

I think that what we are seeing in this country—I think this is the case—is that with the increased use of wine and beer relative to hard liquor a lot of people think there is a very marked distinction; it may have the same alcohol level, but there is a marked distinction in the use of alcoholic beverages.

I know you disagree with that, Mr. Meister, and Mr. Jacobson disagrees with that, but I wonder if Mr. Busch and Mr. Debevc would like to comment on this.

Is this the same for a 17-year-old girl, for example, to have a can of Budweiser as it is to have a shot of Jim Beam?

Mr. **Busch**. Let me comment on a 21-year-old girl whom I like to have a bottle of one of our products. I don't want to say what he or she should do as far as the spirits are concerned; that is not our industry, and I am not going to comment on spirits.

I can only say to you that when you consume a unit of alcohol in a bottle of beer, you are consuming a lot of water. When you are consuming a unit of alcohol in the other beverages you mentioned, you are consuming less water.

Let me also say that when you consume a bottle or two of beer, the Kaiser Permanente study would say that you live longer and you are healthier, your cardiovascular system is better. I hope that that says something about some of us who have been in the industry for some years.

Senator **Danforth**. When I say "17," I am not—obviously you know, in most States. I hope it is a matter of law. We have already passed a bill in Congress to take the position that States should have a 21-year-old drinking age. I am not talking about the drinking age, but I am talking about in the home.

You know, I don't think it is shocking to anybody that in the home parents will say to their kids, "Would you like a beer?" Or, "Would you like a glass of wine?" I can't imagine saying to one of my kids, "Would you like a shot of bourbon?"

Mr. BUSCH. I would just like to add one thing, Senator. If we went to Germany tomorrow, or it we went to France tomorrow, or if we went to Italy tomorrow, we would see exactly happening what you just said, that wine and beer are consumed in the home by people who are at tender ages. And it is done on a daily basis and without exception.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Mr. Chairman, I sit here and listen to this discussion with interest. I would like to ask the first question to Mr. Meister.

At what point do we run back into the moonshine problem again?

Mr. MEISTER. You are seeing increasing amounts of moonshine now, because the tax is truly at the point of consumer resistance. So, we are already at that point.

Senator SYMMS. Then how about in the wine industry, Mr. Debevc? Are there a lot of small wineries that are trying to bootleg wine now?

Mr. DEBEVC. You have to remember that during Prohibition when there was no alcoholic beverage available, families were still allowed to make wine, up to 200 gallons for home use.

Senator SYMMS. For home use?

Mr. DEBEVC. Yes.

Senator SYMMS. I understand that, but they are still allowed to do that, for home use.

Mr. DEBEVC. That is right.

Senator SYMMS. But they are not supposed to sell it.

Mr. DEBEVC. That is correct. But I don't think there is a significant amount. I am sure there are individuals who do it, but I don't think there is a significant amount.

Senator SYMMS. Is the current tax on wine approximately $2.25 per case of 12 bottles?

Mr. DEBEVC. Well, it is 17 cents a gallon, and there are basically 2.4 gallons in a case. However, there is a tremendous amount, about 400 percent more than that, on the State level. We pay tremendous amounts of taxes at the State level.

Senator SYMMS. How much is it on champagne?

Mr. DEBEVC. Three dollars and 40 cents per gallon; so that is 2.4 times that. It would be almost $9 for a case.

Senator SYMMS. Is there basically any difference between champagne, sparkling wine, and wine?

Mr. DEBEVC. No. It is all, basically, 12 percent alcohol. The only thing is that champagne is refermented to give it the gaseous bubbles. However, champagne, I think down through history, has been considered to be an elitist type of product and was probably taxed at a higher level.

However, with this proposal, it will go from $3.40 down to 87 cents. The champagne people love it.

Senator SYMMS. It would go down?

Mr. DEBEVC. Sure it would, because it is tied to alcohol content. That is the whole principle. You know, the wine that we have here doesn't contain any water; it is all grape juice. That is why my 70-year-old father probably is hoeing the vinyards today because I'm here "goofing around," he will say. I mean it is a healthy product, and it doesn't have all these alterations and adulterations, at least the way we make it, that's for sure. I have to drink it; my dad does, too.

Senator SYMMS. Thank you.

Mr. Busch, on this equivalency question, when you go into a bar and order a drink—I hate to be blasphemous in front of a large brewer here, but let's say someone went in and ordered a scotch and water or a bourbon and water, do you think they really get an ounce and a quarter, or do they get closer to two ounces or an ounce and a half?

Mr. BUSCH. Senator, I don't want to be evasive on that answer, but I really don't know. We are not spirits people.

Senator SYMMS. Mr. Meister, what do you think they get?

Mr. MEISTER. I think they get an ounce and a quarter, in most instances.

Senator SYMMS. Are most drinks served under that kind of a metered situation?

Mr. MEISTER. In most of the bar situations, yes, sir.

Senator SYMMS. I see the ads, about, "equivalency," but I am skeptical about the accuracy of the statement "a drink is a drink."

Mr. MEISTER. Well, there are groups such as the National Highway Traffic Safety Administration, the National Institutes on Alcohol Abuse and Alcoholism, there are 36 State driving manuals including 15 of the 20 States represented on the Senate Finance Committee who teach that concept.

Senator SYMMS. Do you want to comment on that, Mr. Busch?

Mr. BUSCH. No. We know how much alcohol, Senator, there is in a 12-ounce bottle of beer, and we know how much water there is there. I don't want to get into an argument with the people in the distilled spirits industry about how much a bartender may pour into a scotch and water, because I really don't know.

Senator SYMMS. Mr. Debevc, at your winery, how do you pay your excise tax?

Mr. DEBEVC. We pay it at the time of removal from bond. When we produce our wine, we pick our grapes, of course, crush them, and then start fermentation, then we have to have a bond on the amount of wine that is there with alcohol in it. When we remove it from bond, then we pay that excise tax to the Federal Government. We do it every 15 days, and we pay the State excise tax to the State government every month. So, it is paid before it is removed to the sales area.

Senator SYMMS. And in the brewery it is the same thing? It goes by a meter at a certain point in the process, is that correct?

Mr. BUSCH. That is correct. And then it is transferred to the Government within a 2-week period and before we receive the revenue from the wholesaler who we have passed the price on to.

Senator SYMMS. And the same thing in a distillery?

Mr. MEISTER. The same thing with us, Senator.

Senator SYMMS. Isn't this a further complication if you can no longer add it to your "cost of sales"?

Mr. BUSCH. If it has been collected from the consumer and it has been given to the U.S. Government.

Senator SYMMS. But it is listed as a profit in your accounting?

Mr. BUSCH. No, sir.

Senator SYMMS. I mean if this proposal passes.

Mr. BUSCH. If this proposal went through, it would be listed as operating profit, which would be taxed at whatever rate that this committee sees fit after deliberation. It would be the corporate rate.

Senator SYMMS. Would you say it would be simpler just to raise the excise tax, rather than do it that way?

Mr. BUSCH. I would hope we wouldn't raise the excise tax, but it would be simpler.

Senator SYMMS. It would be simpler. I am just making the point. This isn't necessarily a simplification process, then?

Mr. BUSCH. It is not.

Senator SYMMS. I want to ask one last question about the farmers' issue here. Are all of these products basically made of grain?

Mr. DEBEVC. No; and grapes?

Senator SYMMS. And grapes. Grapes and grain, though.

Mr. BUSCH. And hops.

Senator SYMMS. And hops.

Mr. BUSCH. Yes.

Senator SYMMS. If the consumers stop consumption, there will be a big dropoff in the demand for grain and hops, and grapes?

Mr. BUSCH. For the price of grain, Senator, because we pay a premium for every bushel of grain that comes out of the field in the use of beer.

Senator SYMMS. Thank you, Mr. Chairman. I see my time is up. So, there is a farmer's side of this issue, also?

Mr. BUSCH. Yes, there is, very much so.

Senator SYMMS. I think I might have observed, Mr. Chairman, that we are paying a huge amount of money out of the Federal treasury right now to try to alleviate the plight of the American farmer.

Mr. DEBEVC. We have none of those subsidies in grapes, Senator.

Senator SYMMS. I understand that.

The CHAIRMAN. Any further questions of this panel?

[No response.]

The CHAIRMAN. If not, let us take Senator Eagleton, and then we will break for lunch.

STATEMENT OF HON. THOMAS F. EAGLETON, U.S. SENATE, STATE OF MISSOURI

Senator EAGLETON. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Tom, for being patient. We appreciate it.

Senator EAGLETON. And I will be very brief because circumstances warrant it, especially immediately before the lunch hour.

Mr. Chairman, I very much sympathize with the dilemma that you and the members of your committee face in trying to simplify the Tax Code and at the same time bring the income tax rates down to 35, 25, and 15, and further to recoup some tax dollars so that at the end of the whole process it is revenue neutral.

I am here this morning to briefly testify in opposition to the proposal with respect to the nondeductibility of excise taxes.

What this change would mean is that the manufacturer—were the proposal to become law—would in effect impose his own sort of manufacturer's sales tax on customers in order to recoup the loss of excise tax deductibility.

So, we would be fostering greater tax regressivity and reducing the progressive impact of the income taxes, all in the name of tax reform—or all in the name of, as we sometimes use it around here in the Halls of Congress, "all in the name of progress." To me, that is not progress.

Regressive taxes are just what the same suggests—going backwards. Regressive tax policies have just that impact. I consider progressive income taxes to be the hallmark of the fair way to collect and impose taxes in this country.

So, whenever the choice is between regressive and progressive, I tilt strongly in favor of the latter.

I thank you, Mr. Chairman.

The CHAIRMAN. Questions of Senator Eagleton?

[No response.]

Senator EAGLETON. Thank you very much.

The CHAIRMAN. Tom, thank you very much.

We are in adjournment until 1:30.

[Whereupon, at 12:44 p.m., the meeting was recessed.]

AFTERNOON SESSION

Senator SYMMS. The committee will resume the hearing. We are now at panel VIII, which is Mr. Morelli, associate general counsel, Midland Enterprises from Cincinnati, OH; Mr. Donohue, president and chief executive officer of the American Trucking Association; Mr. DiBona, president of the American Petroleum Institute; Mr. Scherder, vice president of the Peahody Holding Co.; and Mr. Bergman, executive director of Americans for Energy Independence.

We appreciate all of you gentlemen being here, and we will start right at the top of the list. Mr. Morelli? We are under a 5-minute rule here. The chairman is now here and I will let him say that, but I am sure what he will say is that we want you to try to stay within the 5-minute limit so we can have time for questions.

The CHAIRMAN. Some of these witnesses have been here often enough to know that that is the rule. Why don't you go right ahead, gentlemen? We will start with Mr. Morelli.

STATEMENT OF WILLIAM P. MORELLI, ASSOCIATE GENERAL COUNSEL, MIDLAND ENTERPRISES, INC., CINCINNATI, OH, AND CHAIRMAN, LEGISLATIVE COMMITTEE, THE AMERICAN WATERWAYS OPERATORS, INC.

Mr. MORELLI. Thank you, Mr. Chairman. My name is William Morelli. I am associate general counsel and director of government affairs for Midland Enterprises, Inc., which is one of the Nation's largest inland barge transportation companies. I am also chairman of the Legislative Committee of the American Waterways Operators, which is the national trade association of the domestic inland and coastal barge and towing industry. I appreciate the opportunity to speak on this important issue on behalf of the AWO.

As you are well aware, since 1980 our industry has been paying an excise tax on diesel fuel used in towboat engines. This tax, imposed to help offset the Federal Government's expenditures for new construction on the inland waterways system, has now increased to 10-cents-per-gallon.

This past year, this committee played a crucial role in Senate passage of S. 1567, water resource legislation which would, in exchange for the authorization of six critical inland projects, phase in an additional tax of 10 cents over a period of 10 years beginning in 1988.

We are concerned that, by eliminating the deductibility of excise taxes, one of the goals of the carefully crafted compromise between the Senate leadership and the administration, namely reasonable levels of cost recovery, will be destroyed. We recognize that in fashioning the additional tax burden included in S. 1567, this committee and the administration sought to balance the need of the Federal Government to decrease deficits with the recognition that the barge and towing industry could not absorb additional user fees at the levels which have been previously proposed by the administration.

Our industry acknowledged the difficult task facing this committee and Congress and testified before this committee last September on the positive aspects of the compromise which would increase the user tax on our industry as a means of breaking the deadlock over water resource legislation.

An underlying theme of this legislation was one of moderation in taxing an already ailing barge industry. We note that this committee's report on S. 1567 stated that it was the intent that the increased fuel tax payments not be an undue immediate burden on the users.

This schedule of future tax increases is not intended to be increased further. We believe that the proposal to eliminate the deductibility of excise taxes is at odds with the intent of this language.

Our industry supports the widely held concept that excise taxes are a legitimate, ordinary and necessary expense of doing business and that they should not be included in taxable income. In considering the decision whether to support the fuel tax increase proposed by S. 1567, our industry reviewed the effect any such tax increase would have on our industry, with the assumption that such taxes would be deductible from income.

We estimate that at the current 46 percent income tax corporate level, our industry pays an effective excise tax rate of around 5.4-cents-per-gallon at the current 10-cent-per-gallon fuel tax. Of course, our industry pays the full 10 cents to the Government and then recognizes the benefits of its deductibility. This allows our industry some flexibility in pricing decisions and results in a tax burden which is not confiscatory.

However, as has been mentioned before, the elimination of the deductibility of excise taxes would result in a 54-percent increase at the 35 percent top corporate rate now being proposed in this committee. Certainly, these increases in costs over which our industry has no control will be a serious burden to bear, particularly for an industry which is continuing to have severe economic woes.

It is clear that the increase in the fuel user tax, as proposed in S. 1567, under the nondeductibility option could be devastating to our industry. I would also like to point out that the barge industry faces a situation where an excise tax burden can have significant competitive effects, particularly where its chief competitor is not required to pay a similar tax. While barge lines and trucks pay a tax on diesel fuel, railroads pay no such tax.

Barge lines are the only real competition to railroads for the long haul of high-volume bulk commodities. Since barge lines must compete head to head with an industry which does not have to factor excise taxes into its present structure, any incremental increase in the effective rate of the barge fuel excise tax can effect the delicate competitive balance between barge and rail rates and result in diversion from barge to rail.

We fully appreciate the need to help solve the problem of our burgeoning national deficit. We have shown our commitment to this goal; and it is our hope that the positive national benefits realized this year through the compromise on the water resources legislation will not be irretrievably lost in the name of tax reform.

Thank you.

The CHAIRMAN. Thank you. Mr. Donohue.

[The prepared written statement of Mr. Morelli follows:]

STATEMENT
OF
THE AMERICAN WATERWAYS OPERATORS, INC.

ON THE PROVISIONS
CONTAINED IN THE CHAIRMAN'S TAX REFORM PROPOSAL
AFFECTING THE DEDUCTIBILITY OF FEDERAL EXCISE
TAXES AND TARIFFS

PRESENTED BY

WILLIAM P. MORELLI
ASSOCIATE GENERAL COUNSEL AND
DIRECTOR OF GOVERNMENT AFFAIRS
MIDLAND ENTERPRISES INC.
CINCINNATI, OHIO

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

APRIL 21, 1986

Mr. Chairman and Members of the Committee:

My name is William P. Morelli, and I am Associate General Counsel and Director of Government Affairs for Midland Enterprises Inc., one of the nation's largest inland barge transportation companies. I am also Chairman of the Legislative Committee of the American Waterways Operators, Inc. (AWO), the national trade association of the domestic inland and coastal barge and towing industry. I appreciate the opportunity to speak on behalf of AWO in presenting the views of our industry on the issue of the deductibility of excise taxes.

Since 1980, the inland barge and towing industry has been paying an excise tax on diesel fuel used in towboat engines. This tax, imposed to help offset the Federal government's expenditures for new construction on the inland waterways system, has now increased to $.10 per gallon. This past year, this Committee played a crucial role in Senate passage of S. 1567, water resource legislation which would, in exchange for the authorization of six critical inland waterway construction projects, phase in an additional $.10 per gallon diesel fuel tax on the barge and towing industry over a period of 10 years, beginning in 1988. Under the terms of this legislation, our industry will pay a $.20 per gallon fuel excise tax by 1997. Our concern is that by eliminating the deductibility of excise taxes, the premise on which the carefully crafted compromise between the Senate leadership and the Administration was based -- reasonable levels of cost recovery -- will be destroyed.

We recognize that in fashioning the additional tax burden included in S. 1567, this Committee and the Administration sought to balance the need of the Federal government to decrease deficits with the recognition that the barge and towing industry could not absorb additional user taxes at levels previously proposed by the Administration. Our industry acknowledged the difficult task facing Congress in tackling these issues, and testified before this Committee in September of 1985 on the positive aspects of this compromise which included an increased user tax as a means of breaking the 16-year deadlock over water resources legislation. It is clear that through the many discussions on water resource legislation during this Congress, an underlying theme was one of moderation in taxing an already ailing barge industry. These views were reiterated throughout the Senate proceedings on S. 1567. We note that this Committee's report on S. 1567 stated that it was the intent that "...the increased fuel tax payments (on the barge industry) not be an undue immediate burden on the users....(T)his schedule of future fuel tax increases is not intended to be increased further." (Senate Report 99-228, p. 14.)

The proposal to eliminate the deductibility of excise taxes is at odds with the intent of the Senate and this Committee as embodied in the language just quoted.

Our industry supports the widely held concept that excise taxes are a legitimate "ordinary and necessary" expense of doing business and should not be included in taxable income. In considering the decision whether to support the fuel tax increase proposed in S. 1567, our industry calculated the effect any such tax increase would have on our industry with the assumption that such taxes would be deductible from income.

In an example simplified for sake of comparison, a company paying income tax at the current 46 percent corporate rate would have an effective excise tax rate of $~~.046~~ .054 per gallon at the current $.10 per gallon fuel tax. At the end of the phase in of the additional $.10 per gallon tax proposed in S. 1567, the statutory tax rate of $.20 per gallon would, at the 46 percent corporate rate, result in an effective excise tax rate of $~~.092~~ .108 per gallon. This allows our industry some flexibility in pricing decisions and results in a tax burden which is not confiscatory. However, as one group has calculated, the elimination of the deductibility of excise taxes would result in an 85 percent increase in such taxes at the 46 percent corporate rate, and a 54 percent increase at the 35 percent top corporate rate now being considered by this Committee.

This, or course, reflects the fact that by including the amounts paid in excise taxes as income, a firm must generate additional income to arrive at the same levels of after-tax income derived from the deductibility of excise taxes. Certainly, these increases in costs, over which our industry has no control, will be a serious burden to bear, particularly for an industry which is continuing to have severe economic woes. It is clear that the increase in the fuel user tax proposed in S. 1567, under the non-deductibility option, could be devastating.

I would also like to point out that the barge industry faces a a situation where an excise tax burden can have significant competitive effects, particularly where its chief competitor is not required to pay a similar tax. While barge lines and trucks pay a tax on diesel fuel, railroads pay no such tax. Barge lines are the only real competition to railroads for the long haul of high volume bulk commodities. Since barge lines must compete head-to-head with an industry which does not have to factor excise taxes into its pricing structure, any incremental increase in the effective rate of the barge fuel excise tax can affect the delicate competitive balance between barge and rail rates, and result in diversion of traffic from barge to rail. Our industry has not experienced any appreciable traffic diversion which we can directly attribute to our current fuel user tax, and we hope that not much, if any, will occur as the additional proposed $.10 per gallon tax is phased in over the next 10 years. However, these assumptions on traffic diversion and competitive effects assume that current excise taxes will be accompanied by their deductibility from income. If this were to change, and the effective tax rate increased significantly as a result, the barge industry would likely experience diversion, further hastening the decline and instability of many inland waterway carriers. It is our hope that this Committee recognizes that so long as another mode with which we compete does not have to concern itself with excise taxes and their deductibility, the barge industry will be at a severe disadvantage in the competitive marketplace if the excise tax deduction is eliminated.

The barge and towing industry fully appreciates the need to pitch in and help solve the problem of our burgeoning national deficit. We have shown our commitment to this goal. However, we ask that this Committee not jeopardize the health of the barge and towing industry by eliminating the deductibility of excise taxes, especially in light of our competitive position with the railroad industry which pays no comparable tax. We hope that the positive national benefits realized this year through compromise on water resource legislation will not be irretrievably lost in the name of tax reform.

Mr. Chairman, I thank you for the opportunity to present this statement and will be happy to answer any questions you or your colleagues might have.

STATEMENT OF THOMAS J. DONOHUE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN TRUCKING ASSOCIATIONS, INC., WASHINGTON, DC

Mr. DONOHUE. Thank you, Mr. Chairman. I am Tom Donohue, president and chief executive officer of the ATA; and I speak today on behalf of my association and the Coalition Against Regressive Taxation, which represents dozens of organizations and companies opposed specifically to the excise tax and tariff changes included in the Finance Committee's recent markup.

Mr. Chairman, for myself and for the others, let me say that we appreciate your help in arranging this hearing so that we can discuss and evaluate the critical and emotional issues associated with this excise tax proposal. The organizations that participate in CART's weekly meetings oppose several of the committee's proposed changes: Of course, the elimination of deductibility of excise taxes and tariffs; the indexing or increasing of fuel, tobacco and alcohol taxes; and the fivefold to sixfold increase in the wine tax. The fact that more than 100 people are testifying before the committee today gives an indication of the feeling in the community.

The proposed changes in excise taxes and tariffs are selective tax hikes that hit hardest at those least able to pay. Eliminating the deductibility of excise taxes paid by businesses is not reform. It is an unprecedented departure from current tax policy. It is an unfair redefinition of the concept of business expenses to withdraw the ability of business to deduct money spent on excise taxes. It is, in some people's minds, revolution, not reform.

These taxes and tariffs are every bit as legitimate as the cost of goods, labor, Social Security, or unemployment taxes. The committee's proposal changes the rules of the game in such a way that no one in business today could have predicted or anticipated.

Let me just take a moment on trucking. Our situation is that we are already the highest federally taxed industry in the country. Mr. DiBona might disagree, but it depends on how you roll the numbers. Last year truck owners paid $6.8 million in Federal excise taxes, derived from fuel, equipment and heavy vehicle use, in addition to a growing State burden in taxes. Over the last 5 years, our taxes have gone up 55 percent. In addition, that money we have paid in is in the banks, so to speak.

There is $13 billion in the Highway Trust Fund right now not being spent, and it will shortly be $17 billion.

The committee's plan would cost these owners as much as $3.7 billion annually in lower income or in higher taxes. A typical owner-operator, for example, who pays $6,900 a year in excise taxes, would pay an additional $2,400 right out of his pocket, a 35-percent increase. Now, unlike some businesses—and Mr. Chairman, I am sure from the quotes we have both made in the newspapers, we want to talk about this—the trucking industry will not be able to pass along all of the increased costs because of a couple of issues.

First, we have a relatively constant freight volume, since 1979; high competition because of more entrants in the business. Shippers are now beginning to act as carriers, and the owner-operators have particular problems in their business. Not only that, competition with the railroads, who pay no excise taxes—and in this instance who would have a double advantage to us—would cause us to think twice about passing on some of the costs.

Third, existing business arrangements take some time and, as was indicated today, the cash flow period of time where you pay it and then go collect it. And then finally, as you all know, the big companies would be able to stand this much better than the small.

However, I will admit that all costs will eventually be paid by the consumer, either in increased costs, lost jobs, smaller profits, or lost wages. You heard about the study today that basically outlines how the smaller companies and the least advantaged taxpayers would carry a significant burden of the excise taxes, when and if they are passed on to the ultimate consumer.

And I am not going to spend a good deal of time going into those numbers because they have already been reported on. But in short, the proposed changes would virtually destroy the tax relief for the lower income people, while it provides more advantage for people at higher levels.

I would also point out, Mr. Chairman, a little study that was done that indicates some questions as to the constitutional legality and the law as it pertains under the GATT. Let me summarize, if I might then, by saying that this proposal takes $75 billion out of the private economy and reallocates it to cover someone else's tax advantage.

The ultimate regressive nature of this is that those less fortunate will pay for it, and it cannot be easily passed on to the consumers especially in low-profit companies in highly competitive industries, and it may be illegal under the constitutional and the GATT agreements.

Mr. Chairman, for these reasons, we would urge the Finance Committee to reject these proposals. And if I might just add one sentence, I would like to say that we were very disappointed to hear this morning's testimony by the Assistant Secretary of the Treasury endorsing the excise tax concepts which increase our taxes and take away the deductibility. I consider his logic to be a rejection of the principles that were in the President's original tax reform bill and an indication that they will go to any length to get a bill, no matter what is in it.

Thank you very much, Mr. Chairman.

[The prepared written statement of Mr. Donohue follows:]

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON FINANCE

Statement of the
AMERICAN TRUCKING ASSOCIATIONS

HEARING ON
EXCISE TAX AND TARIFF CHANGES
PROPOSED AS PART OF TAX REFORM

Thomas J. Donohue
President and Chief Executive Officer

My name is Thomas J. Donohue; I am President and Chief Executive Officer of the American Trucking Associations. ATA is a federation representing all types and sizes of for-hire and private motor carriers.

ATA's membership includes over 3,500 individual firms, plus 51 state trucking associations and 11 conferences of different trucking specialties, which together represent tens of thousands of other carriers.

SUMMARY

The trucking industry is firm in its opposition to proposals that would end the deductibility of federal excise taxes and tariffs and index federal fuels taxes. These changes would drive the trucking industry's already high effective tax rate up to intolerable levels, even if the income tax rate were cut to 35%.

Truck owners pay more federal excise taxes than any other taxpayers--$6.8 billion per year. Ending deductibility would cost them more than $2 billion, a sum the industry cannot possibly absorb, given current economic conditions of stiff competition, low margins, and high bankruptcy rates. Yet their principal competitors, railroads, pay no federal excise taxes. As a result, companies would not generally be able to pass the taxes forward, and many would be driven out of business.

Moreover, it is objectionable on principle to deny the deductibility of a necessary and inescapable business cost. These taxes and tariffs are every bit as legitimate a deduction as the cost of goods, labor, or Social Security and unemployment taxes. By forcing businesses to count as income an amount they now collect and remit directly to the government, the changes would be very disruptive to prices or business dealings with many industries that supply trucking.

The proposal to index fuel taxes, just when prices are near or at their lows, is also likely to saddle highway users with an unfair share of tax increases. Tax reform should be paid for by broadening the income tax base, not by arbitrarily selecting certain excise taxes for potentially steep increases.

CURRENT LAW

Excise taxes and tariffs (or customs duties) are levied on a broad range of goods and services. The amounts collected and remitted to the federal government are either excluded from gross receipts (just as state sales taxes are) or are deductible as an ordinary business expense (just like payroll taxes). For the buyer of a taxable or dutiable good, the full cost of the product, including the tax or tariff, is treated like similar, untaxed products. For example, businesses deduct the full cost of telephone service, including the 3% federal excise tax collected and remitted by the telephone company.

Truck owners are subject to several categories of excise taxes, plus tariffs on imported trucks and parts. Current federal excise tax rates, and the amounts collected from trucks in fiscal 1985, are shown below. (Tariffs, ranging as high as 25%, push the total even higher; however, detail on collections is unavailable.)

Excise Tax and Rate	FY85 Receipts (billion $)
Gasoline--9 cents per gallon	2.4*
Diesel fuel--15 cents per gallon	2.4*
New trucks, trailers, and parts--12% of retail price	1.4
Heavy vehicle highway use tax--$100 to $550 per year	0.4
Tires (over 40 lbs.)--varies with weight	0.2
Total for all trucks	6.8

*Truck portion only (assumed to be 27.5% of gasoline tax and 91.9% of diesel tax, based on Federal Highway Administration data.)

Source: Budget of the United States Government--Fiscal Year 1987.

This $6.8 billion total has doubled in the last three years, as the gasoline tax has risen from 4 to 9 cents, the diesel tax from 4 to 15 cents, and the highway use tax from a maximum of $240 to $550. Commercial trucking as a whole (for-hire and private fleets) pays $4.9 billion, and individuals (who may use trucks for business as well as personal purposes), $1.9 billion.

The taxes are levied at various stages. In particular:

o Gasoline and tire taxes are manufacturers' excise taxes.

o The tax on new trucks, trailers and parts added within six months is imposed at time of first retail sale and must be depreciated by the purchaser under the same rules as the vehicle itself.

o The diesel tax is paid by the dealer in the case of retail sales and by the user in the case of fleet owners who fill up their own trucks.

o The highway use tax is paid annually by owners of trucks having a registered weight of more than 55,000 pounds.

Together, these taxes cost the typical long-haul truck operator, driving a tractor-trailer 100,000 miles, almost $7000 a year.

PROPOSED CHANGES

The markup document now before the Finance Committee contains three types of changes to federal excise taxes and tariffs, plus related technical changes:

(1) an end to deductibility for all excise taxes and tariffs, imposed in such a way that all payers of those levies would be effectively subject to a tax at the top corporate rate (35% under the plan), even for companies and individuals with losses or credits available for regular tax purposes;

(2) indexing of fuel, tobacco, and alcohol taxes, such that tax rates would rise if prices rise but would not fall below

current rates if prices fall;

(3) a five- to six-fold increase in the excise tax on wine.

Nondeductibility is the most consequential of these changes. With a 35% top corporate rate under the plan, ending deductions would raise $62.6 billion over fiscal years 1987-91, according to Joint Committee on Taxation staff estimates released April 7. If the corporate rate winds up higher, the cost of nondeductibility would go up accordingly. Indexing would raise $11.2 billion, and the wine tax change $1.5 billion.

The technical changes would assure that each tax and tariff would be counted as income by someone, generally the business that now collects the tax, but possibly further "upstream" in the case of the diesel tax.

IMPACT ON THE TRUCKING INDUSTRY

These changes would be brutal for trucking. Trucking is a highly competitive industry. There are now more than 33,000 holders of operating authority from the Interstate Commerce Commission, with an even larger number of private and intrastate carriers. Preliminary 1985 data show that ICC-authorized carriers had a very narrow profit margin of only 2.2%, with roughly a third operating at a loss. Nondeductibility would worsen these totals significantly, and would push many more carriers into the red. Some would be forced out of business altogether.

Most truck owners would lose direct deductions only for the highway use tax. However, their costs for fuel and equipment would go up by just as much as if they paid the other excises and tariffs directly. That is because refiners, manufacturers, and importers of fuel, trucks, parts, and tires would attempt to increase their prices enough to recover the cost of their lost deductions. Trucking companies, which need those products to stay in business, would have little ability to fend off the price increases. Meanwhile, the changes would cause cash flow or other difficulties for carriers and a host of related industries: truck stop operators and other fuel vendors; truck and trailer makers and dealers; and manufacturers, distributors and dealers of parts and tires.

Little Pass-Through by Trucking Firms

Truck owners would not generally be able to pass on their higher costs to customers, for two reasons. First, many of them compete head-to-head with railroads, which pay virtually no federal excise taxes. (The only exceptions are for piggyback trailers and for their own highway vehicles.) Carriers that compete directly with rail would have little or no opportunity to pass on costs if the business would otherwise be diverted. Second, even where there is no competition from another mode, the large number of existing or potential trucking competitors (including the shipper, which can easily get permission to truck its own freight) would often prevent pass-throughs of the costs. Many short-haul carriers are in this situation, for instance.

Since 1978, the number of trucking companies has more than doubled, yet the physical volume of freight remains unchanged, indicating how intense competition has become and how hard it would be for most carriers to pass along the higher tax costs.

Impact on For-Hire Carriers

To measure the impact on the trucking industry from the loss of deductibility, ATA's Statistical Analysis Department calculated the tax paid in 1984 on purchases of fuel and equipment and on highway use for all 1414 interstate carriers that reported to the ICC. These firms comprise nearly one-fourth of the for-hire (interstate and intrastate) industry. Their actual effective federal income tax rate in 1984 was a relatively high 28.6%. If they had to pay a 35% tax on the federal excises included in the products they bought, their combined income tax rate would have soared to 41.8%--a 46% increase. (A study by the Joint Committee on Taxation staff for 1980-83 found an even higher effective tax rate for those years, 38.2%. Nondeductibility would have pushed this rate above 50% for those years.)

Impact on Owner-Operators and Marginal Firms

The impact would be harshest on marginal carriers and owner-operators. Roughly one-third of reporting ICC-authorized carriers operated in the red in 1985. All of these companies would be severely squeezed by having to pay a 35% tax on the amount of highway use tax they paid, and by facing sharp increases in product prices.

A typical owner-operator drives 100,000 miles per year and pays nearly $7000 (directly or indirectly) in federal excise taxes. Assuming a taxable income of $20,000, a married taxpayer would be in the 15% bracket for regular income tax but would owe at a 35% rate on his or her highway use tax. Furthermore, higher costs for a tractor, tires, and fuel as a result of nondeductibility for the sellers or manufacturers would drive the owner-operator's disposable income down by more than 13%.

Size of Price Increases to be Absorbed

Nondeductibility would spell sharply higher prices for a trucking company's major purchases: equipment and fuel. In general, a business would have to increase its selling price by 54% of the amount of an excise tax to remain whole.

A 54% increase in the $6.8 billion of excise taxes paid by all truck owners amounts to $3.7 billion annually. The for-hire industry would pay almost half this sum, which would likely exceed total industry profits.

This would roughly increase the price of diesel fuel by 8 cents a gallon, heavy tires by 8%, and tractors, trucks, and trailers by 7%. Fuel costs would go still higher if the diesel and gasoline taxes were indexed. At current prices, the diesel tax equals approximately 25% of the pretax price, and the gasoline tax 12%.

PROBLEMS WITH INDEXING FUEL TAXES

Indexation of fuel taxes presents additional problems beyond the potential high cost when coupled with nondeductibility. Indexation would either swell the Highway Trust Fund, into which truck owners have already paid a large unspent balance, or it would lead to fuel users paying part of the tax into the general fund. Either approach is unfair.

The Highway Trust Fund currently has an unspent balance of over $13 billion, a sum that is projected to rise above $17 billion by 1990. It is unreasonable to require truck owners and other fuel users to keep adding to an account that is far in surplus and growing rapidly.

It would be even more inequitable to expect fuel purchasers to pay for tax relief for all other taxpayers by diverting the indexed portion of fuel tax receipts into general revenues. Moreover, the volatility of fuel prices makes this a very unsuitable source of funding general tax relief. Finally, if the proposal were implemented now, when fuel prices appear to be at or near a low from which they will most likely rebound sharply, highway users would be especially penalized.

CONCLUSION

The proposals to end deductibility for excise taxes and tariffs and to selectively raise excises are unfair and misguided. They would have a harsh impact on the trucking industry, which already pays extremely high rates of both income tax and excise taxes. They would be most punitive for owner-operators and marginal companies, driving many of them into the red or even out of business.

In short, these proposals are the antithesis of true tax reform, which includes lower effective rates for currently over-burdened taxpayers and a more level playing field. The Committee should reject these ideas before proceeding with tax overhaul.

The CHAIRMAN. I am a half-hour late in getting to this, and I apologize for that. I promised Senator Symms he could ask one question. He had a 2 p.m. appointment, and he wants to ask this question before he leaves.

Senator SYMMS. I apologize first to all the panel members that I have to go to the office. I have a long standing meeting that I can't get out of.

The question that I am very concerned about is the broad question of cost of doing business. As you run a trucking company you collect excise taxes and pay them to the Government. Then you include the tax in the sales price. When you pay the tax to the government you includethat as a cost of doing business, the same as paying your 7 percent FICA taxes. Is that correct?

Mr. MORELLI. Yes, sir.

Senator SYMMS. Isn't this going to completely disrupt your procedures if we take away the deductibility? Wouldn't it be better from the standpoint of accounting procedures just to raise it?

Mr. DONOHUE. From the point of view, if I might speak first, of the cost of doing it—the change in the way the process goes, the cash-flow arrangements, and everything else—strictly on a hypothetical case, it would certainly be better to raise it than to change all the rules of the game.

Senator SYMMS. Thank you very much. Thank you, Mr. Chairman, for letting me indulge the committee here.

The CHAIRMAN. Thank you, and again I apologize for coming in late. Mr. DiBona, are you really higher taxed than trucks?

Mr. DIBONA. Excuse me, sir?

The CHAIRMAN. Are you higher taxed than trucks?

Mr. DIBONA. Oh, yes, sir. [Laughter.] Without question, we certainly pay more. [Laughter.]

Mr. DONOHUE. They pay more; we pay a higher percentage.

The CHAIRMAN. Go right ahead.

STATEMENT OF CHARLES J. DiBONA, PRESIDENT, AMERICAN PETROLEUM INSTITUTE, WASHINGTON, DC

Mr. DIBONA. Thank you, Mr. Chairman. I am Charles DiBona, president of the American Petroleum Institute, a trade association that represents all segments of the industry in this country. The API opposes the proposed elimination of excise tax deductibility which would make the tax structure more inequitable rather than less.

It would distort economic decisionmaking by its discriminatory, negative effects on industries whose products are subject to excise taxes. It would make the Tax Code more regressive. Reform of the income tax through a tax on a tax represents a novel doctrine opposed to traditional concepts of taxation based on net income. Nondeductibility would have a particularly severe impact on the petroleum industry.

It is the only industry subject to the crude oil windfall profit tax. It is the main contributor, together with the chemical industry, to Superfund excise taxes. And with excise taxes applied to gasoline and other fuels, petroleum and its products accounted for over 45 percent of the $37 billion total excise taxes paid in the United States last year.

This industry is the most highly taxed of all major industries. Figures from the Joint Committee on Taxation, for example, show that even without the windfall profits tax, the industry in recent years has paid taxes at rates above the average of other industries. I don't know whether they include the trucking as a separate entity in that study.

When the windfall profits tax is included, however, the petroleum industry in 1984 carried a Federal tax burden two-thirds as high again as that of other industries. Motor fuel taxes alone account for almost a third of all Federal excise taxes. Federal and State motor fuel taxes have been increased significantly in recent years, and motorists already bear a relatively heavy burden.

As motor fuel taxes are regressive, a further increase in these taxes would compound that regressive impact. Without concrete legislative language, quantitative estimates of the impact of the nondeductibility proposal cannot be made. However, assuming a maximum corporate income tax rate of 35 percent, nondeductibility would mean that for an affected firm to maintain its after-tax income, it would have to raise its prices by 54 cents for each dollar of excise taxes it currently pays.

The amount which would in practice be passed through would depend on market conditions. For the motor fuel tax, because of the comparatively low short-term and higher long-term responsiveness of motor fuel consumption—that is elasticity to an economist—it is likely that initially almost all of the increase would be passed through. Over time however, the petroleum industry would absorb a higher portion of the tax.

The windfall profits tax creates a special problem. Domestic oil producers cannot pass this tax on to consumers because the price of oil is determined in world markets, and foreign oil is not subject to the tax. Although this tax currently raises little if any revenue, it could become important should the price of oil recover somewhat.

Indeed, with windfall profits tax deductibility disallowed and with the proposed 35 percent maximum income tax rate, a $1 increase in the price of crude oil could raise a company's Federal tax liability by as much as $1.05, 70 cents of windfall profits tax and then 35 cents of income tax. Rather than making the windfall profits tax more onerous, this committee should consider repealing it.

The nondeductibility proposal would also particulary affect the oil and chemical industries because of the special excise taxes they pay under the Superfund Program. The House Superfund bill would increase the tax enormously, with the two industries funding over 80 percent of the 5-year $10 billion effort, even though petroleum is responsible for only about 15 percent of the wastes affected by the program.

Nondeductibility of these taxes would make this situation even more inequitable. Given the currently depressed state of the petroleum industry and the importance of its viability to the U.S. economy and national security, elimination of deductibility of excise taxes is a particularly bad idea and it has been proposed at a particularly bad time.

Thank you.

The CHAIRMAN. Thank you, sir. Mr. Scherder.

[The written prepared statement of Mr. DiBona follows:]

TESTIMONY

SUBMITTED BY

CHARLES J. DIBONA

PRESIDENT, AMERICAN PETROLEUM INSTITUTE

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

APRIL 21, 1986

Introduction

Federal excise taxes on petroleum industry products were about $17 billion in fiscal 1985, or almost half of the federal revenues generated by all excise taxes. Federal excise taxes on motor fuels in themselves equaled about $12 billion, or about one-third of all federal excise receipts. Revenues from tariffs on crude oil and petroleum products also are substantial -- over $200 million in fiscal 1985. Therefore, the proposals before this Committee to make federal excise taxes and tariffs nondeductible for income tax purposes and to adjust some excise taxes including motor fuel taxes for inflation have important implications for the petroleum industry. These proposals should be evaluated in terms of their potential effects on the Nation's energy position as well as for their general economic effects. The following discussion examines these proposals from both energy and economic policy perspectives.

I. Nondeductibility: A Disguised Increase in Excise Taxes and Tariffs

Although the proposal to eliminate the deductibility of federal excise taxes and tariffs in computing business income taxes is presented as an income tax reform, the proposal actually is an indirect way of raising excises and tariffs. Not all firms subject to income taxation would be affected by nondeductibility; only those firms that pay excise taxes or tariffs would be directly affected. Indeed, under the "anti-avoidance" provision of this proposal, even firms that operate at a loss would have to pay income tax "at the maximum corporate tax rate" on so-called income equal to their excise tax and tariff liabilities. This would be a radical departure from the traditional concepts of income taxation.

At the proposed 35 percent maximum corporate tax rate, the nondeductibility provision would raise a firm's tax bill by 35 percent of the amount of its federal excise taxes and tariffs. To maintain its after-tax income, a firm affected by the nondeductibility provision would have to raise its prices. But, since a firm typically would retain only 65 percent of any additional income resulting from a price increase, it would have to raise prices by 54 cents -- not 35 cents -- for each dollar of excise taxes and tariffs in order to recoup the 35 cents additional tax (65 percent of 54 cents equals 35 cents).

The proposed anti-avoidance provision would cause the tax bills of firms operating at a loss also to rise by 35 percent of their excise tax and tariff liabilities. However, if no adjustments are made to the current proposal, these firms might use their losses to offset income from all or part of any revenue increases. Thus, they might fully recover the increase in their taxes by raising their prices by less than 54 percent of their excise taxes and tariffs. A similar result could occur in the case of firms subject to the minimum tax contained in the Chairman's proposal. Therefore, the nondeductibility proposal as it stands -- even with its anti-avoidance provision -- would have some disparate effects on firms in different income tax positions.

Some have suggested that the current proposal be modified so that those firms that do not pay the maximum corporate tax rate on additional income (such as firms operating at a loss) would not obtain a competitive advantage. The details of how this would be accomplished are not yet known. However, such a modification probably would involve even higher taxes on firms operating at a loss than would be imposed on them under the current proposal. In addition, it probably would cause the prices of taxed products to rise by even more than they would under the current proposal.

In any event, the elimination of federal excise tax and tariff deductibility would put intense pressure on affected firms to raise their prices. Indeed, it is likely that affected firms typically are earning only competitive rates of return currently. Thus, affected firms probably would have to raise their prices merely to remain economically viable.

The extent to which firms would be able to pass on the increases in excise taxes and tariffs that are implicit in the nondeductibility provision largely depends upon market conditions. If the quantity demanded of the particular taxed product is not sensitive to price changes (a relatively inelastic demand), firms would be able to pass on all or almost all of the tax increase without losing much sales volume. In this case, consumers of the taxed product would bear most or all of the tax burden. However, if demand for the taxed product is highly sensitive to price changes (relatively elastic demand), firms would not be able to pass on the tax increase without losing a large volume of sales. In this case, although the product's consumers may pay somewhat higher prices for the taxed product, they usually would bear only a fraction of the total tax burden.

The demand for most goods is neither perfectly elastic nor perfectly inelastic. Therefore, under the nondeductibility proposal, the consumers of products subject to excise taxes and tariffs typically would pay higher prices for these goods, and the firms producing the taxed goods would suffer reductions in their volumes and after-tax receipts. Productive facilities in the affected industries would be less fully utilized, some plants might shut down, and employment in these industries would decline.

II. Implications of Excise Tax and Tariff Nondeductibility for the Domestic Oil Industry

As the table below indicates, federal excise taxes on petroleum industry products totalled about $17 billion in fiscal 1985. U.S. Department of Commerce figures indicate that customs duties on crude oil and petroleum products were more than $200 million in 1985. Thus, based on 1985 figures, the proposed nondeductibility provision accompanied by a maximum 35 percent income tax rate would impose an additional federal tax burden of about $6 billion (35 percent of $17.2 billion) on the petroleum industry. Naturally, nondeductibility would impose a smaller burden if future tariffs and excise taxes such as the windfall profit tax are smaller, and it would impose a greater burden if the income tax rate is above 35 percent.

EXCISE TAXES ON PETROLEUM INDUSTRY PRODUCTS IN FISCAL 1985
($ Thousands)

Manufacturers' Excise Taxes	
Gasoline	$ 9,062,387
Special Fuels and Retailers Taxes	
Noncommercial aviation gasoline	9,688
Noncommercial aviation fuel other than gasoline	73,005
Diesel and special motor fuels	2,430,165
Inland waterway fuel	39,287
Windfall Profit Tax, Total	5,073,159
Environmental Taxes	
Petroleum	42,490
Chemicals including petrochemicals	222,579
Hazardous substances	7,888
Total -- Petroleum Industry Products	$16,960,648
Total -- All Excise Taxes	$37,004,944

Source: Internal Revenue Report of Excise Taxes, March 26, 1986.

In the short term, the demand for petroleum products -- particularly gasoline -- is widely believed to be highly inelastic. As discussed above, in such cases producers are able to pass on a large portion of tax increases to their customers while maintaining their sales. The experience of the past 10 years or so, however, indicates that over longer periods of time people do cut their demand for petroleum products in response to higher prices. The long uptrends in both petroleum products consumption and gasoline consumption were reversed in the late 1970s and early 1980s in response to the price increases of the 1970s. Thus, in the short term the petroleum industry probably could pass on a large portion of an effective increase in taxes, but in the longer term the industry would be forced to curtail its activities. Thus, the burden of excise tax and tariff increases ultimately would be shared between consumers and the industry -- its employees as well as stockholders.

An important exception to the generalization that petroleum consumers, workers, and producers would share the burden of increased excise taxes and tariffs is the crude oil windfall profit tax (WPT), an excise tax imposed on the difference between the market price of domestically produced crude oil and various base prices for different categories of oil. The price of crude oil is determined in world markets. Domestic producers cannot sell their oil at a price above the cost of imported oil of like quality. Thus, if WPT deductibility were eliminated, domestic oil producers would bear the entire burden of this tax increase.

The WPT currently yields little if any federal revenue because of the recent steep fall in oil prices. Nevertheless, it discourages U.S. oil development because domestic oil producers know that, even with WPT deductibility permitted for income tax purposes, the WPT would appropriate up to 70 percent of future increases in oil revenues. Moreover, should oil prices rise substantially, the WPT would again become a significant revenue raiser and would have a greater inhibiting effect on domestic oil investments.

Elimination of the WPT deductibility for income tax purposes would make this tax an even greater obstacle to domestic petroleum development. With WPT deductibility disallowed and a 35 percent maximum income tax rate, a $1 increase in oil revenues could raise a company's federal tax liabilities by as much as $1.05 ($0.70 in WPT plus $0.35 in income tax).

Clearly, the WPT, which was enacted in 1980, was intended to operate in a far different economic environment for the oil industry than exists currently. The WPT is an anachronism that should be abolished. It certainly should not be made potentially more onerous and counterproductive.

Another area that would be affected by the nondeductibility provision is Superfund taxation. The oil and chemical industries have been paying excise taxes of about $300 million per year for this toxic waste cleanup program. Nondeductibility would effectively increase these taxes. Furthermore, the House Superfund bill contains an enormous increase in the excise taxes on the oil and chemical industries, an increase that would be magnified if these taxes were not deductible. This bill would require the oil and chemical industries to fund over 80 percent of a 5-year $10 billion effort to clean up abandoned, toxic waste sites, despite the fact that the oil and chemical industries are responsible for only a small fraction (about 15 percent) of abandoned wastes. This not only would be inequitable, but it also would be irresponsible at a time when the domestic petroleum industry is faced with a financial problem that has important implications for the Nation's energy security and economic well-being. The cost of financing this societal effort simply should be spread more broadly through the total economy.

In addition to completely bearing the burden of WPT nondeductibility, the oil companies would bear part of the burden associated with increases in other petroleum product excises.

Increasing the petroleum industry's overall tax burden would be inequitable since, as demonstrated below, the oil industry already is more highly taxed than other industries generally.

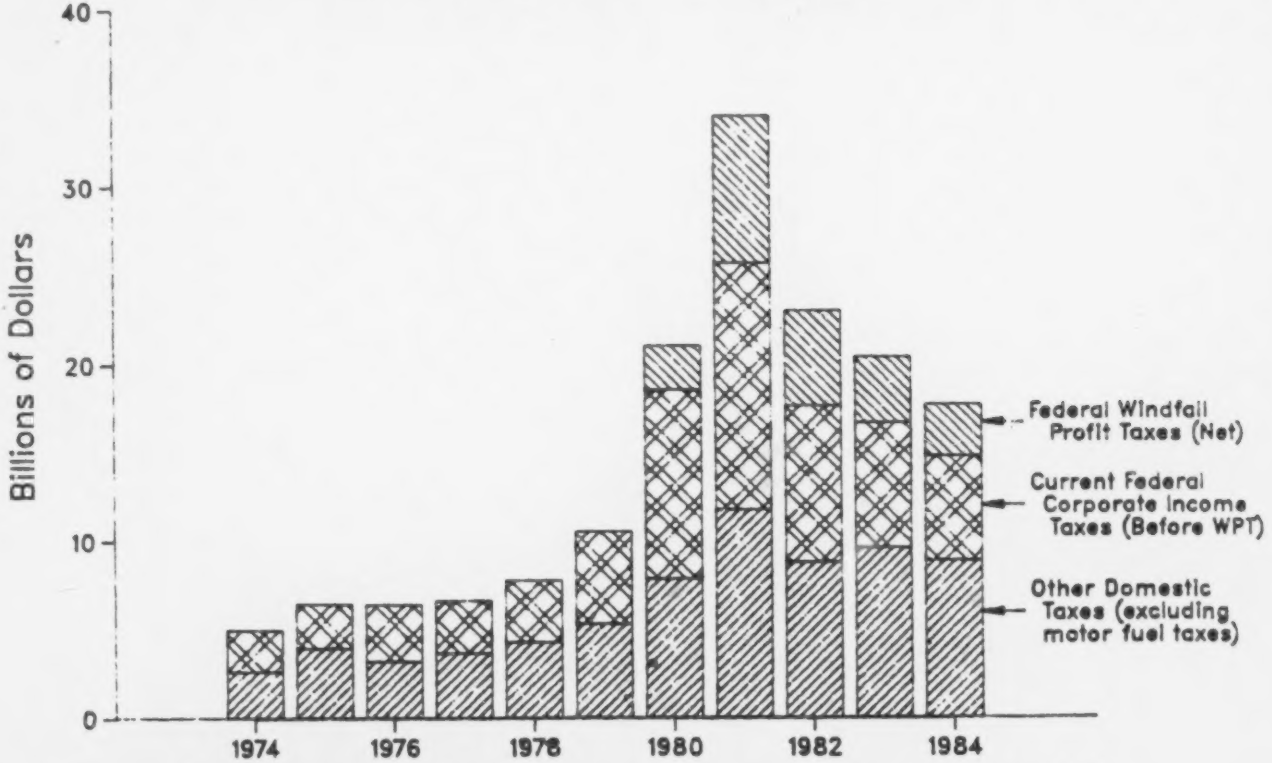
Recent Petroleum Industry Taxes

The following discussion focuses on two federal taxes: the corporation income tax and the WPT. Of course, the petroleum industry pays substantial amounts in other taxes including severance taxes and many other state and local taxes. Figures for 1984 (the latest full-year data available) indicate that $17.7 billion in domestic taxes, not including $11.5 billion in motor fuel taxes, were levied on the 21 leading petroleum companies. Figure 1 displays the domestic taxes (excluding motor fuel taxes) paid by this group during the period 1974-84. They also paid substantial foreign taxes.

Studies by the staff of the Joint Committee on Taxation, the Petroleum Industry Research Foundation, Inc. (PIRINC), and the American Petroleum Institute all show that petroleum companies tend to pay tax at higher effective rates than non-oil companies. This is true for both their domestic and foreign operations.

The staff of the Joint Committee on Taxation found that 23 leading petroleum corporations paid 21.3 percent of their pre-tax U.S. income in federal income tax for 1983, while the average for all the corporations examined by the Joint Committee staff for 1983 was 16.7 percent. They found a similar difference between petroleum and non-petroleum firms for each of the years 1980 through 1982.

Figure 1: U.S. Taxes On Domestic Operations Paid By Leading Petroleum Companies



NOTE: Data for 1974–81 are from a Price Waterhouse sample of 17 leading companies. Data for 1982–84 are from API samples. 1982 data are from 19 companies. 1983–84 data are from 21 companies. Differences typically involve small firms.

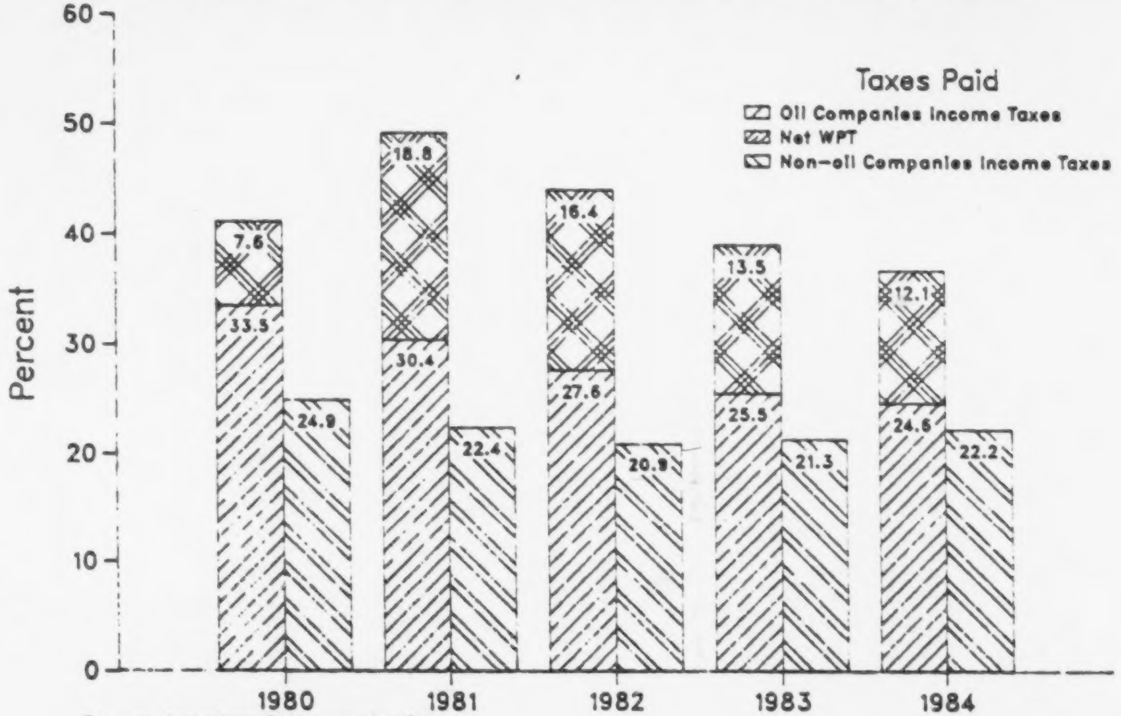
According to the Joint Committee on Taxation study for the period 1980-1983, the oil companies' average effective federal income tax rate was 23 percent while during the same period the average for all industries was 18 percent. Similarly, PIRINC found that during 1980-82, the large U.S. petroleum companies paid federal income taxes at a three-year average rate of 26 percent compared to an average rate of 16 percent for the nearly 200 large non-oil companies included in the Joint Committee on Taxation study.

These studies examine only the corporation income tax. Because the federal windfall profit tax is deductible from income taxed under the corporation income tax, the figures actually understate the effective corporation tax rates that the petroleum industry would have faced in the absence of the WPT.

The windfall profit tax, of course, should be considered an integral part of the petroleum industry's federal tax burden. The industry paid $76 billion of windfall profit tax from its enactment in 1980 through fiscal year 1985. As stated above, because crude oil prices are set in a world market, oil companies cannot pass this tax forward in higher prices.

When the corporation income tax and windfall profit tax are considered together, the leading 21 companies in the petroleum industry had an effective tax rate of 37 percent in 1984 -- two-thirds higher than that for similar firms in non-petroleum industries. (See Figure 2.) The differential was even greater in earlier years, reaching a peak of 120 percent in 1981, when the leading petroleum companies paid 49 percent of their income

Figure 2: Comparative Federal Tax Burden of Leading U.S. Oil and Non-oil Industrial Companies



Source: American Petroleum Institute

Note: 21 Oil and 100 Non-oil Companies. Oil income taxes shown for 1980–1984 are what would have been paid without the Windfall Profit Tax, which is shown net of the income tax offset. In the WPT computational procedure, the WPT is deducted from income, and income tax is levied on the residual. Therefore, if there were no WPT, the income tax would be higher, as shown above. WPT is not shown for Non-oil companies because the amounts are negligible.

to the federal government through just these two taxes. The 1980-84 average effective federal tax burden for petroleum was 43 percent.

Full-year data for 1985 are now available for 13 of the 21 leading oil companies. The average effective income tax and WPT rate for these 13 companies remained about the same in 1985 as it was in 1984. Preliminary data also suggest that oil companies continued to have a higher effective tax rate than non-oil companies through 1985. In summary, despite its difficult economic circumstances in recent years, the petroleum industry continued to pay federal taxes at higher rates than other industries.

The Domestic Oil Industry's Current Situation

Imposition of higher taxes on the domestic oil industry not only would be inequitable but also would weaken the industry's financial position at the most difficult time in its recent history. Since early December 1985, crude oil spot market prices have fallen by more than one-half. The price fall has been so severe that, after adjustment for inflation and tax changes, some recent prices received by domestic crude oil producers have been about the same as the prices they received in the late 1960s. The fall in petroleum product prices has been commensurate with the drop in crude oil prices. Consequently, the industry has cut back its operations substantially, and companies have announced plans to cut still further.

Based on a recent survey of companies, the Oil & Gas Journal has estimated that domestic capital spending by all oil industry segments will fall by 24 percent in 1986, following a 19 percent reduction in 1985. The exploration-production segment's spending is estimated to fall by 25 percent in 1986, after a 21 percent drop in 1985. Moreover, the company cutbacks announced since this survey suggests an even greater reduction in the industry's spending this year. For example, Exxon has announced it now plans to cut its domestic capital and exploration spending by 36 percent this year.

Activity in the oil patch already has been reduced substantially. The number of active drilling rigs in the U.S has plummeted from almost 2,000 at the end of last year to under 1,000 today. This compares with a peak figure of about 4,500 in late 1981. The active rig count now is near its 1971 level, the lowest recorded in the post-World War II era. Furthermore, advance indicators of drilling activity suggest that the decline in drilling may have further to go. The number of active seismic crews and the number of applications for permits to drill wells have fallen precipitously during the past few months.

Not only are fewer new wells being drilled, but many producing wells are being shut in. Shut-ins occur because the value of the oil produced is not sufficient to cover the costs of maintaining production. Stripper wells (wells producing less than 10 barrels of oil per day) are particularly vulnerable, although some larger wells also have been taken out of production. A survey taken by the National Stripper Well Association earlier this year indicated that about 100,000 of the Nation's 460,000 stripper wells would be shut in at wellhead prices of $15 per barrel or less. Indeed, the closing of many of these wells already has occurred. Since stripper wells, on average, produce about 3 barrels per day, the closing of 100,000 such wells would reduce domestic oil production by about 300,000 barrels per day. Because environmental regulations typically require secure plugging of inactive wells to prevent possible damage to water supplies, it probably will be uneconomic ever to re-open most shut-in stripper wells.

Less drilling and more shut-ins will reduce domestic oil production. Such production already is down about 110,000 barrels per day in 1986. Estimates of future production vary, but analysts agree that continuation of low oil prices will drastically lower U.S. oil production. For example, Data Resources Inc., a leading economic consulting firm, projects that U.S. oil production would fall from its 1985 level of 10.5 MMB/D to 8.1 MMB/D in 1995 if the price of oil is in the $13-15 range in 1986-1988 and then rises to $29 per barrel by 1995. Assuming somewhat higher oil prices, the Energy Information Administration recently projected domestic oil production of only 7.1 MMB/D in 1995. An American Petroleum Institute survey of oil companies suggests that domestic production could fall by at least this much if oil prices stay at relatively low levels, such as those recently experienced.

Employment has fallen markedly in the oil industry and related industries. For example, Exxon has reduced its staff by about 20 percent since 1981, and Chevron recently announced it will cut its work force by about 10-15 percent during the next year or so. Recently released U.S. Labor Department figures indicate that 24,000 jobs were lost in the oil and gas producing industry during March alone, and that the Texas unemployment rate has suddenly risen well above the national average. Based on industrial input-output relationships compiled by the U.S. Department of Commerce, the American Petroleum Institute has estimated that for each billion dollar reduction in exploration-production expenditures, oil-field employment will be cut by about 11,000 and supplier industry employment by about 9,000. Thus, a 1984-1986 spending reduction of about $13 billion, the amount estimated by the Oil & Gas Journal, can be expected to reduce oil-field and supplier employment by about 260,000. Moreover, capital spending cuts in the downstream segments of the industry will cause additional employment losses.

Finally, although more than 100 U.S. refineries have shut down since 1981 (over one-third of the domestic refineries operating in 1981), the domestic refining industry currently is operating at only about three-quarters of capacity.

Clearly, the decline in the domestic oil industry that is underway does not augur well for the Nation's energy security. Moreover, if low oil prices persist, oil consumption would be stimulated. Higher consumption combined with declining domestic oil production would lead to a substantial rise in U.S. oil imports. Higher taxes would sap the domestic industry's strength even further, and thus they would accelerate the likely movement toward greater national reliance on imported oil.

III. Additional Consequences of Eliminating Federal Excise Tax and Tariff Deductibility for Income Tax Purposes

1. Nondeductibility would reduce overall consumer satisfaction and future economic growth.

The selective increases in excise taxes and tariffs that nondeductibility would bring about would accentuate the distortions in the economy caused by these taxes. Consumers would be dissuaded from purchasing taxed products, and resources would be forced out of the production of these items. Consumers would wind up with a less satisfying basket of goods, and resources -- labor and capital -- would move into less productive and remunerative pursuits. The net result would be lower economic growth and reduced economic well-being.

2. Nondeductibility would be a regressive tax.

A recent study by de Seve Economics Associates has found that individuals with incomes of less than $20,000 per year would pay about 23 percent of the taxes generated by nondeductibility, although these individuals account for only about 12 percent of total income. At the other end of the income scale, individuals with annual incomes over $100,000 are estimated to pay about 6 percent of the taxes generated by nondeductibility, although they account for about 14 percent of total income.

3. Nondeductibility would in effect set important social and economic policies without specific legislative consideration.

Nondeductibility would establish policies without careful legislative consideration. It would cause the prices of certain items (those with excise taxes or tariffs on them) to rise, thereby discouraging their consumption and penalizing the consumers of these items as well as the employers and workers who produce these items. If legislators wish to discourage consumption of certain items and penalize certain groups of employers and workers in the process, they should clearly specify this so that the electorate can readily perceive the nature of the proposal.

4. Nondeductibility effectively would allow some federal excise taxes to raise general revenues for the first time.

Revenues raised by the federal excise taxes on gasoline and diesel fuel heretofore have been earmarked for the Highway Trust Fund. They have been used only for specific programs, mainly highway construction and repair. The nondeductibility proposal represents a departure from this long-established system, but legislative consideration has not specifically been given as to whether this is desirable.

5. Nondeductibility of federal excise taxes and tariffs would establish an important precedent for expanding the income tax base.

It long has been widely accepted that federal excise taxes and tariffs are deductible as costs for computing the taxable income of businesses. For income tax purposes, these levies have been viewed as "ordinary and necessary" business expenses akin to costs such as the purchases of raw materials and labor services. A departure from traditional practice in the treatment of such a substantial expense for many companies would open the door to further such departures.

IV. The Proposed Establishment of Ad Valorem or Inflation-Adjusted Excise Taxes

The Committee proposal calls for adjusting the excise taxes on alcohol, tobacco, and motor fuels to account for price changes. Presumably (the proposal is not specific), this could be accomplished either by establishing ad valorem taxes (percentage rates applied to the prices of taxed products) or by adjusting the existing taxes upward by the changes in a general price index such as the consumer price index. The proposal would not permit the tax rates to fall below the levels in current law.

The petroleum industry historically has had an important role in the motor fuel tax collection process. Because of its role in the collection system, the industry does have some views on the best methods of levying motor fuel taxes and determining tax rates.

It has been the oil industry's experience that the most simple, easily administered, and yet sure method is a flat rate of cents-per-gallon tax as periodically adjusted by a legislative body. Other methods are accompanied by more difficulties. A motor fuel tax based solely on value and not expressed on a cents-per-gallon basis creates compliance difficulties, contains more potential for error and abuse, and involves more audit effort. In addition, there would be costs involved in moving to new accounting systems.

In recent years, some jurisdictions have experimented with variations of the flat rate, whereby the rate remains in terms of cents-per-gallon, but moves automatically in relation to some factor such as a percent of average retail or wholesale price of fuel, the consumer price index, highway maintenance costs, or fuel consumption factors. None of these methods allows the degree of scrutiny which can be brought to bear by the deliberate and specific acts of a legislative body. Dedicated taxes such as the motor fuels taxes should be subjected to periodic legislative review to assess whether they are accomplishing their objectives.

Finally, we also are concerned that motor fuels consumers as well as the petroleum industry are being asked to bear an inordinate portion of taxes. The federal excise tax on gasoline was more than doubled just three years ago. Moreover, such taxes are a major source of state revenues. All states have motor fuels taxes, and many have increased their rates in recent years.

STATEMENT OF DANIEL B. SCHERDER, VICE PRESIDENT, FINANCIAL ADMINISTRATION, PEABODY HOLDING CO., ST. LOUIS, MO, AND VICE CHAIRMAN, TAX COMMITTEE, NATIONAL COAL ASSOCIATION

Mr. SCHERDER. Mr. Chairman and members of the committee, my name is Daniel Scherder. I am vice president of financial administration for the Peabody Holding Co. in St. Louis, MO; and I am also vice chairman of the tax committee of the National Coal Association.

I wish to briefly address the specific implications of the nondeductibility of the black lung tax paid by my industry. Under current law, the coal producer pays a black lung tax of $1.10 per ton on underground coal and $0.55 per ton on surface-mined coal. Industry contributions to the black lung fund were about $575 million in 1985 and will increase to over $650 million in 1986.

Since the proposal requires all companies to pay tax on the excise tax, even if the company is in a cash-loss position, the net effect of including black lung in the excise tax category is one of raising the black lung tax by more than 50 percent. Even though the Senate Finance Committee recognized the need to restore certain current law provisions taken away from the coal industry by the House proposals, the nondeductibility of black lung excise taxes more than offsets any restoration of benefits by the committee.

The total dollar increase on the industry over the 5-year projection period would be over $1 billion. This is ironic in view of the fact that Congress recently rejected an administration proposal to increase the black lung taxes by 50 percent and, in fact, passed as part of the reconciliation bill only a 10 percent increase instead.

Further, none of the revenue raised by this proposal would accrue to the black lung fund or any of its beneficiaries. The numbers referred to above are derived from an independent study commissioned by the National Coal Association and performed by the accounting firm of Price Waterhouse. The conclusions are based on information secured by Price Waterhouse from companies producing over 50 percent of the Nation's coal. It is from the very largest to those producing less than half a million tons annually. A copy of the study is appended to my statement.

It is an anomaly that the black lung tax is even considered an excise tax. It was not conceived as nor does it function as a Federal revenue source. It is a levy assessed against the coal producer to finance a fund to support former employers that contracted a disease in the workplace. The funds generated by the fee are dedicated for a specific social purpose, not unlike the Social Security Program mandated by the Federal Insurance Compensation Act, the Federal unemployment compensation system, or workmen's compensation at the State level. In fact, if the payments were made directly for the health care benefits rather than into the fund, there would be no question of their deductibility, either under current law or proposed law.

In making this comparison, I am certainly not advocating that the employer contributions to these programs be included in the proposal, but merely showing that the black lung payments are for the funding of a specific health care program rather than payment of an excise tax. Because coal is generally sold domestically under medium- and long-term coal supply agreements, this increased tax liability in most cases cannot be passed on to our customers.

In addition, this proposal would place domestic producers at a further disadvantage with the foreign producers on coal exports. The coal industry is currently in a very depressed state. With falling oil prices, we do not project a turnaround in the near future. The added tax burden arising from the loss of deductibility of the black lung excise tax would result in a burden under which many marginal coal companies could not survive and most companies will be severely affected.

For the reasons I have stated, if excise taxes are to become nondeductible, the black lung excise tax by its very nature should be excluded.

Thank you. If you have any questions, I will try to answer them.

The CHAIRMAN. Thank you. Mr. Bergman.

[The prepared written statement of Mr. Scherder follows:]

NATIONAL COAL ASSOCIATION

STATEMENT OF THE

NATIONAL COAL ASSOCIATION
AND THE
MINING AND RECLAMATION COUNCIL

BY DANIEL B. SCHERDER
VICE PRESIDENT, FINANCIAL ADMINISTRATION OF
PEABODY COAL COMPANY

TO THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON THE

DEDUCTIBILITY OF FEDERAL EXCISE TAXES AND TARIFFS

April 21, 1986

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE:

MY NAME IS DANIEL B. SCHERDER. I AM VICE PRESIDENT, FINANCIAL ADMINISTRATION OF THE PEABODY COAL COMPANY, HEADQUARTERED IN ST. LOUIS, MISSOURI. I AM ALSO VICE CHAIRMAN OF THE TAX COMMITTEE OF THE NATIONAL COAL ASSOCIATION.

I AM HERE ON BEHALF OF NATIONAL COAL ASSOCIATION AND MINING AND RECLAMATION COUNCIL TO SPEAK AGAINST THE CONCEPT OF DENYING DEDUCTIBILITY WITH RESPECT TO THE BLACK LUNG TAX PAID BY MY INDUSTRY. THE PROPOSAL WOULD SEEM TO CREATE INCOME FOR ALL BLACK LUNG EXCISE TAX PAYERS, WHERE ACTUALLY, INCOME DOES NOT EXIST. A LIABILITY EQUAL TO THE BLACK LUNG EXCISE TAX WOULD BE ASSESSED, EVEN IF A COMPANY WAS IN A LOSS POSITION. THE ENTIRE THEORY CONTRAVENES THE IDEA OF TAXING INCOME.

I WISH TO BRIEFLY ADDRESS THE IMPLICATIONS OF THE NON-DEDUCTIBILITY OF THE BLACK LUNG EXCISE TAX IN THE COAL INDUSTRY.

UNDER CURRENT LAW THE COAL PRODUCER PAYS A BLACK LUNG TAX OF $1.10 PER TON ON UNDERGROUND COAL AND $.55 PER TON ON SURFACE-MINED COAL. INDUSTRY CONTRIBUTIONS TO THE BLACK LUNG FUND WERE ABOUT $575 MILLION IN 1985 AND GOING TO $650 MILLION IN 1986. SINCE THE PROPOSAL REQUIRES ALL COMPANIES TO PAY TAX ON THE EXCISE TAX, EVEN IF THE COMPANY IS IN A LOSS POSITION, THE NET EFFECT IS ONE OF RAISING THE BLACK LUNG TAX BY 54 PERCENT. THE TOTAL DOLLAR IMPACT ON THE INDUSTRY OVER THE PROJECTION PERIOD IS OVER $1 BILLION. THIS IS IRONIC IN VIEW OF THE FACT THAT

CONGRESS RECENTLY REJECTED AN ADMINISTRATION PROPOSAL TO INCREASE THE TAX 50 PERCENT, AND PASSED AS PART OF THE RECONCILIATION BILL A 10 PERCENT INCREASE INSTEAD. FURTHER, NONE OF THE REVENUE RAISED BY THIS PROPOSAL WOULD ACCRUE TO THE BLACK LUNG FUND OR ITS BENEFICIARIES.

THESE NUMBERS ARE DERIVED FROM AN INDEPENDENT STUDY COMMISSIONED BY THE NATIONAL COAL ASSOCIATION AND PERFORMED BY THE ACCOUNTING FIRM OF PRICE WATERHOUSE. THE CONCLUSIONS ARE BASED ON INFORMATION SECURED BY PRICE WATERHOUSE FROM COMPANIES PRODUCING OVER FIFTY PERCENT OF THE NATION'S COAL, AND CONSISTING OF PRODUCERS FROM THE VERY LARGEST TO THOSE PRODUCING LESS THAN HALF A MILLION TONS ANNUALLY. A COPY OF THE STUDY IS APPENDED TO MY STATEMENT.

IT IS AN ANOMALY THAT THE BLACK LUNG TAX IS EVEN CONSIDERED AN EXCISE TAX. IT WAS NOT CONCEIVED AS, NOR DOES IT FUNCTION AS, A FEDERAL REVENUE SOURCE. IT IS A LEVY ASSESSED AGAINST THE COAL-PRODUCER TO FINANCE A FUND TO SUPPORT FORMER EMPLOYEES THAT CONTRACTED A DISEASE IN THE WORKPLACE. THE FUNDS GENERATED BY THE TAX ARE DEDICATED FOR A SPECIFIC SOCIAL PURPOSE -- NOT UNLIKE THE SOCIAL SECURITY PROGRAM MANDATED BY THE FEDERAL INSURANCE COMPENSATION ACT, AND THE FEDERAL UNEMPLOYMENT COMPENSATION SYSTEM, OR WORKMAN'S COMPENSATION AT THE STATE LEVEL. PLEASE UNDERSTAND THAT IN MAKING THIS COMPARISON, I AM CERTAINLY NOT ADVOCATING THAT THE EMPLOYER CONTRIBUTIONS TO THESE PROGRAMS BE INCLUDED IN THE PROPOSAL BEFORE THE FINANCE COMMITTEE.

SPECIFIC TAXES AND SET FEES CAN CURRENTLY EQUAL HALF THE GROSS REVENUE FROM A COAL OPERATION. BEFORE A PRODUCER CAN THINK IN TERMS OF ANY PROFITS THAT MIGHT BE REALIZED, THE COAL PRODUCER:

- MUST PAY THE LANDOWNER A ROYALTY ON THE COAL PRODUCED UNLESS HE HAS TIED UP HIS OWN CAPITAL IN OWNERSHIP OF COAL IN PLACE.
- MAY HAVE TO PAY ROYALTIES OF AROUND 8% (12-1/2% IN THE CASE OF FEDERAL LEASES) OF THE SELLING PRICE.
- MUST PAY THE STATE A SEVERANCE OR PRODUCTION TAX RANGING FROM 3-1/2 TO 5% OF THE GROSS SELLING PRICE FOR EASTERN COAL TO AS MUCH AS 30% IN THE WEST.
- MUST PAY AS MUCH AS 4.4% OF THE GROSS SELLING PRICE TO FUND THE BLACK LUNG RESERVE FOR EMPLOYEES THAT ARE MAINLY NOT HIS OWN.

THE COAL INDUSTRY IS CURRENTLY IN A VERY DEPRESSED STATE. WITH FALLING OIL PRICES WE DO NOT PROJECT A TURN-AROUND IN THE NEAR FUTURE. THE ADDED TAX BURDEN ARISING FROM THE LOSS OF DEDUCTIBILITY OF THE BLACK LUNG EXCISE TAX WOULD RESULT IN A

BURDEN UNDER WHICH MANY MARGINAL COMPANIES COULD NOT SURVIVE.

FOR THE REASONS I HAVE STATED, IF EXCISE TAXES ARE TO BECOME NON-DEDUCTIBLE, THE BLACK LUNG EXCISE TAX, BY ITS NATURE SHOULD BE EXCLUDED.

THANK YOU. IF YOU HAVE ANY QUESTIONS I'LL BE HAPPY TO TRY TO ANSWER THEM.

Price Waterhouse

The Economic Impact Of The Senate Finance Committee Tax Reform Proposals On The Coal Industry

Prepared for:

NATIONAL
COAL
ASSOCIATION

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April, 1986

THE ECONOMIC IMPACT OF THE SENATE FINANCE COMMITTEE TAX REFORM PROPOSALS ON THE COAL INDUSTRY

On March 18, 1986, the Chairman of the Senate Finance Committee unveiled his proposals from which the Committee is to draft a tax reform bill. While many of the provisions in the current tax law that relate specifically to coal companies are unchanged in this document, there are several others that will have a significant impact on the future tax burden of coal companies. The following is an update to the Price Waterhouse report The Economic Impact of the President's Tax Reform Proposals on the Coal Industry, September 1985, and subsequent reports evaluating the Ways and Means Staff Options and the House Bill (H.R. 3838).

This update briefly discusses those sections of the Senate Finance Committee proposals that have an impact on the coal industry, along with an analysis of the projected cost of each individual provision and of the bill taken as a whole. For a detailed explanation of the methodology used in this study, please refer to the September 1985 report.

Results of the Analysis

Table 1 presents projected tax liabilities under both current law and the Finance Committee proposals. The change in tax liability over the six-year period from almost $2.7 billion under current law to nearly $3.8 billion under proposed law represents a projected 44.3 percent increase in taxes for the coal industry if the proposals are enacted. The annual increases range from 11.9 percent in the first year (when the only change is the early

TABLE 1

PROJECTED TAX LIABILITIES
PRESENT LAW AND SENATE FINANCE COMMITTEE PROPOSALS
U.S. COAL INDUSTRY - 1986-1991

($ millions)

	Current Law	Proposed Law	Difference
1986	443.2	496.1	52.9
1987	430.7	193.9	-236.8
1988	427.5	689.0	261.5
1989	431.6	740.2	308.6
1990	470.4	818.9	348.5
1991	472.3	846.6	374.4
1986-1991	2,675.6	3,784.7	1,109.1

repeal of the investment tax credit) to 79.3 percent in 1991. (The decrease in 1987 is due to the "cashing out" of all remaining investment tax credits, as will be explained later.) While the projections end at 1991, it is likely that future tax liabilities will be closest to those projected for the later years.

Six-year totals of the estimated changes in tax liability attributable to each provision of the Finance Committee proposals are shown in Table 2. The total increase of over $1.1 billion during the period 1986-1991 is the net effect of six specific proposals to change the tax law.

The year-by-year effects of each provision can be found in Table 3. Three of the provisions represent a significant increase in the taxation of the industry, a fourth results in a small increase, and two others will benefit coal companies. The four changes that will increase the taxes paid by coal companies are (1) the repeal of the investment tax credit (ITC), (2) slight modifications in the Accelerated Cost Recovery System (ACRS) for depreciable property, (3) the non-deductibility of excise taxes, and (4) the change to an Alternative Minimum Tax (AMT). The two proposals that partially offset the increase in taxes are (1) the reduction of the top marginal corporate tax rate from 46 percent to 35 percent, and (2) the mandatory refund of unused ITC carryovers.

One way to assess the impact of the Finance Committee proposals on the coal industry is to divide the proposals into two categories, those which affect all industries in general and those which have additional effects on the coal industry. Two of the proposals have an especially severe impact on the coal industry. They are: (1) the disallowance of a deduction for federal excise taxes (including the black lung excise tax), and (2) the change in the minimum tax rules to include (a) the excess of

TABLE 2

SUMMARY OF PROJECTED FIVE-YEAR CHANGES IN TAX LIABILITIES, DUE TO SENATE FINANCE COMMITTEE PROPOSALS

U.S. COAL INDUSTRY - 1986-1991

($ millions)

Provision	1986-1991
Change in Depreciation Allowances	$ 7.5
Non-Deductibility of Excise Taxes	1,016.0
Decrease in Corporate Tax Rate	-578.5
Repeal of Investment Tax Credit	556.6
Mandatory Refund of Investment Tax Credit Carryovers	-269.0
Change in Corporate Minimum Tax	376.8
TOTAL DIFFERENCES	$1,109.1

NOTE: Details do not add due to rounding.

TABLE 3

CHANGE IN TAX LIABILITY DUE TO SENATE FINANCE COMMITTEE PROPOSALS, BY PROVISION,

U.S. COAL INDUSTRY

($ millions)

ELEMENTS OF TAX LIABILITY DIFFERENCES FOR ALL COMPANIES	1986	1987	1988	1989	1990	1991	Total
Change in Depreciation Allowances	N/A	5.2	9.9	6.6	(1.3)	(12.9)	7.5
Non-Deductibility of Excise Taxes	N/A	224.1	202.2	200.0	183.0	206.7	1,016.0
Decrease in Corporate Tax Rate	N/A	(61.4)	(122.9)	* (124.1)	(123.8)	(146.3)	(578.5)
Repeal of Investment Tax Credit	52.9	95.7	85.1	85.1	101.3	136.5	556.6
Mandatory Investment Tax Credit Carryover Refund	N/A	(519.8)	50.3	78.7	82.7	39.1	(269.0)
Change in Corporate Minimum Tax	N/A	19.4	36.9	62.4	106.7	151.4	376.8
Total Differences	52.9	(236.8)	261.5	308.6	348.5	374.4	1,109.1
Percentage Change	11.9%	-55.0%	61.2%	71.5%	74.1%	79.3%	41.5%

NOTE: Details do not add due to rounding.

percentage depletion over the adjusted basis of the property, and (b) 50 percent of the excess of book income over alternative minimum taxable income as preferences for the alternative minimum tax. The combined impact of the excise tax disallowance and the AMT is to increase coal industry taxes by about $1.4 billion. In other words, those items that are mining-specific produce a substantial total tax increase to be borne by the coal industry.

There are four other parts of the Finance Committee proposals that will have an impact on the amount of taxes paid by the coal industry over the next five years. These provisions are those that affect corporations in general and are (1) the modifications to the Accelerated Cost Recovery System, (2) the decrease in the top marginal corporate tax rate, (3) the elimination of the investment tax credit, and (4) the mandatory cash refund for all unused ITC carryovers. The aggregate effect of these four provisions is not nearly as great as for those that disproportionately affect mining companies, amounting to a net tax savings of nearly $300 million over the period 1986 to 1991.

Depreciation. The Accelerated Cost Recovery System will be largely retained in the Finance Committee proposals. The two changes that affect coal companies are (1) the lengthening of depreciation allowances for real property from 175 percent declining balance over 19 years to straight-line over 30 years, and (2) indexing depreciation allowances for inflation in excess of 2 percent per year. As under current law, nearly all of the equipment used by the coal industry will be depreciated over 5 years. The net effect of the proposal will be to increase taxes slightly ($7.5 million) over the projection period.

Non-Deductibility of Federal Excise Taxes. A very significant proposal from the standpoint of the coal industry is the non-deductibility of federal excise taxes, specifically the black lung excise tax. Coal companies paid nearly $550 million in black lung excise taxes in 1985. Since the proposal requires all companies to pay tax on the excise tax, even if the companies suffer losses, the net effect is one of raising the black lung excise tax by 54 percent. The revenue effect of this provision over the projection period is expected to total $1 billion. (Note that the cost attributable to this provision in Tables 2 and 3 is calculated assuming a 46 percent marginal tax rate since all of the base-broadening provisions are considered before the rate reduction.)

Corporate Tax Rates. The Finance Committee proposal calls for a top marginal corporate tax rate of 35 percent, as compared to the top rate of 46 percent under current law. The effect of this proposal will be to decrease taxes by nearly $580 million during the period 1987 to 1991. The effect would be larger if the lower tax rate applied for all of 1987 rather than only half of the year. Of course, part of the magnitude of this decrease can be attributed to the broader base of income to which the lower rate is applied.

Repeal of the Investment Tax Credit. As in other tax reform proposals, the investment tax credit would be repealed by the Finance Committee plan. Over the six-year period (six years in this case because the repeal would be effective March 1, 1986, instead of in 1987), coal companies would pay nearly $560 million in additional taxes due to the loss of the investment tax credits. The effect is largest in the later years of the projection period because coal companies are projected to have larger tax liabilities in the later period. Thus, under current law, the carryover of investment tax credits could be more fully utilized later in the projection period.

Mandatory Cash Refund of Unused Investment Tax Credit Carryovers. The Finance Committee is proposing to make a cash refund to all companies that have unused ITC's effective the beginning of the first taxable year after the repeal of the credit. Only 70 percent of the carryover stock would be refunded, however, presumably because the Committee feels that 70 percent represents the average percentage across industries of unused investment tax credits that would be claimed by 1991. With regard to the coal industry, it is estimated that coal companies will benefit over the projection period because they would otherwise be able to claim less than 70 percent of this unused ITC. As a result, more value from the ITC carryovers will be received from a cash refund than would have occured if the carryovers were gradually used up. The net benefit of this provision to the coal industry over the five-year period is projected to be almost $270 million. As a result, the net effect of the two ITC provisions in the Finance Committee's proposal will be to raise taxes for coal companies by approximately $290 million.

Change in Corporate Minimum Tax. The current law "add-on" minimum tax would be repealed and replaced with an alternative minimum tax that would be similar in form to the present alternative minimum tax for individuals. This part of the bill will raise coal industry taxes by $380 million over the first five years of enactment.* Three items of tax preference are the source of this large tax increase: (1) the excess of incentive depreciation over nonincentive depreciation, (2) the excess of percentage depletion over the adjusted basis of the property, and (3) 50 percent of the excess of book income over alternative minimum taxable income. Since percentage depletion is retained in its current form for the ordinary tax, the preference for percentage depletion accounts for a large share of the alternative minimum tax paid.

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* Because some of the coal operations are subsidiaries of other corporations that are not likely to be subject to the AMT, this revenue estimate is 35 percent lower than if the AMT were based on the coal operations alone.

Another large part of the minimum tax increase is the new preference item for depreciation of personal property. The preference in this case is the difference between ACRS depreciation allowances and the amount of depreciation that would be allowed under the tax-exempt leasing rules of Section 168(j) of the Internal Revenue Code. Since much of the property used in the coal mining industry has an assigned class life of 10 years, the preference for depreciable personal property will be substantial over the first five years. After that time, negative depreciation preferences will accumulate and the net effect of this item will be smaller.

Finally, coal companies will be affected by the provision to count as a tax preference 50 percent of the excess of book income over alternative minimum taxable income. About 40 percent of the surveyed companies paying the AMT will owe tax on this preference at some point during the projection period. Typically, this preference will have a larger effect in the earlier years during the transition to the new tax system.

Summary

The total effect of the Senate Finance Committee proposal on the coal industry will be a substantial increase in tax liabilities. It is significant that a large share of the increase in tax liability for the coal industry is a result of the changes in tax rules relating to the deductibility of excise taxes and the new alternative minimum tax rules, which hit the coal industry especially hard. Those industries that rely heavily on depreciable property or pay excise taxes are likely to pay a disproportionately large share of the tax increase for corporations.

Unlike prior tax reform proposals, there are few transition rules in the Finance Committee plan to temper the large tax increase. As a result, the full effect of the proposals is felt almost immediately with a 61 percent increase in tax liabilities for 1988. After a one-time benefit of "cashing out" the unused investment tax credits in 1987, the increase in taxes on the industry averages over 70 percent per year.

FIFTH YEAR IMPACT

($ - millions)

Provision	President's Proposal 1990	House-Passed Bill 1990	Finance Committee Proposal 1991
CHANGE IN DEPRECIATION ALLOWANCE	52.8	195.1	(12.9)
CHANGE IN DEPLETION ALLOWANCE	360.1	223.5	—
DIVIDENDS PAID DEDUCTION	(14.4)	(2.6)	—
CHANGE IN TREATMENT OF CAPITAL GAIN ON DEPRECIABLE ASSETS	8.5	25.8	—
CHANGE IN TREATMENT OF ROYALTY INCOME	17.3	17.4	—
DECREASE IN CORPORATE TAX RATE	(299.4)	(257.2)	(146.3)
RECAPTURE OF WINDFALL BENEFIT DUE TO EXCESS DEPRECIATION	8.0	—	—
ELIMINATION OF INVESTMENT TAX CREDIT	234.5	227.9	136.5
CHANGE IN CORPORATE MINIMUM TAX	(49.3)	32.9	151.4
RECAPTURE OF MINE DEVELOPMENT EXPENSES	—	10.1	—
NON-DEDUCTIBILITY OF EXCISE TAXES	—	—	206.7
MANDATORY INVESTMENT TAX CREDIT CARRYOVER REFUND	—	—	39.1
TOTALS	318.0	472.8	374.4
PERCENT INCREASE IN TAX LIABILITY	67.6	100.51	79.3

Note: DETAILS DO NOT ADD DUE TO ROUNDING

FIVE-YEAR IMPACT OF TAX PROPOSALS

($ - Millions)

Provision	President's Proposals 1986 - 1990	House-Passed Bill 1986 - 1990	Finance Committee Proposal 1987 - 1991
CHANGE IN DEPRECIATION ALLOWANCE	(1.1)	447.4	7.5
CHANGE IN DEPLETION ALLOWANCE	904.9	764.8	—
DIVIDENDS PAID DEDUCTION	(34.2)	(8.4)	—
CHANGE IN TREATMENT OF CAPITAL GAIN ON DEPRECIABLE ASSETS	12.4	117.4	—
CHANGE IN TREATMENT OF ROYALTY INCOME	38.1	37.3	—
DECREASE IN CORPORATE TAX RATE	(909.2)	(809.9)	(578.5)
RECAPTURE OF WINDFALL BENEFIT DUE TO EXCESS DEPRECIATION	217.3	—	—
ELIMINATION OF INVESTMENT TAX CREDIT	820.1	781.1	556.6
CHANGE IN CORPORATE MINIMUM TAX	(46.9)	229.1	376.8
NON-DEDUCTIBILITY OF EXCISE TAXES	—	—	1,016.0
MANDATORY INVESTMENT TAX CREDIT CARRYOVER REFUND	—	—	(269.0)
TOTALS	1,001.4	1,651.7	1,109.1
PERCENT INCREASE IN TAX LIABILITY	45.40	74.96	41.50

Note: DETAILS DO NOT ADD DUE TO ROUNDING

STATEMENT OF ELIHU BERGMAN, EXECUTIVE DIRECTOR, AMERICANS FOR ENERGY INDEPENDENCE, WASHINGTON, DC

Mr. **BERGMAN**. Thanks a lot, Mr. Chairman. I am Elihu Bergman, executive director of Americans for Energy Independence. We are a Washington-based policy organization. We identify issues that involve the role of energy in the economic health and national security of the country and promote informed discussion of them. In doing so, we represent no particular interest. We enjoy the luxury of applying a single yardstick in selecting and measuring issues: Is it good for the country?

It is a personal pleasure, Mr. Chairman, for me to appear before you because I graduated from an outstanding educational institution in your State, Reed College. I used to think that the presidency of Reed was perhaps the most difficult job in the country; but after observing the proceedings here and following them, I am convinced that chairing the panel attempting to write tax laws even beats the presidency of Reed in toughness.

The **CHAIRMAN**. The difference is that none of us have tenure. [Laughter.]

Mr. **BERGMAN**. And also, he relies on voluntary contributions; you don't. [Laughter.]

Of course, we recognize that tax policy is a means of asserting national goals and priorities; and what you do here, the decisions that you arrive at, will have some bearing on the energy future and the energy security of this country. We have to recognize, that we still are not out of the woods; and that despite the euphoria associated with free-falling oil prices and the benefits to the economy and to individual consumers, that oil and oil consumption still represent the weak link in our energy system.

The goal, therefore, of national policy should be to discourage—to continue to discourage—oil consumption by at least maintaining it flat; at best continuing to reduce it.

The prospects out there in the future don't look too bright. We had two studies last year—one from the Congressional Research Service and another from the U.S. Geological Survey which projected as much as a 50-percent decline in U.S. domestic oil production in the 1990's. We are not discovering any more Prudhoe Bays. If that happens and we maintain our current rates of oil consumption, we will have to import the difference.

That is about 4 million barrels of oil a day; and there is one sure source that can supply it is OPEC. The demand side doesn't look too bright either. We really don't know what lower oil prices will do to conservation and alternatives, but we do know that out there there is about 2 million barrels' worth of dual-use natural gas/oil capacity; and there is also a retired 2 million barrels a day worth of electric-generating capacity, which could be called back into service as the requirement for electricity increases. So, we are talking about a maximum potential demand increase for oil of 4 million barrels a day, and a potential supply shortfall of 4 millon.

We also should consider requirements in the rest of the world. Earlier this month, the international energy forum meeting in Tokyo projected that Asian demands alone—the ASEAN countries, China and Japan—could add approximately another 7 million barrels of oil of demand to the world system by the year 2000. Now, we all know the consequences of these requirements. We have been there before, and we know the devastation that skyrocketing oil prices, created by excessive demand for oil, and the dependence on insecure sources to supply it can do to our economic system.

The remedies? The remedies aren't too pleasant. We have talked about various sorts of oil taxes including an oil import tax and a tax on gasoline. As for a gasoline tax, the combined Federal and State taxes in the United States average 20 cents a gallon; in Europe, the comparable tax ranges between about 93 cents and $1.83.

Finally, public opinion seems to favor some action to limit free-falling oil prices. The Wall Street Journal reported last Friday the results of a Wall Street Journal/NBC poll, which disclosed that, by a ratio of 2 to 1, Americans favor measures to arrest an oil price drop. And by 53 to 36 percent, the public would favor an oil import tax.

I think that the American public is perhaps more perceptive and wiser than conventional political wisdom credits them.

Finally, I hope that when this committee comes out of the doorless, and windowless room, into which I understand it will be led, that some of your decisions will be helpful in securing the objective of a more secure energy future for the country.

Thank you very much.

[The prepared written statement of Mr. Bergman follows:]

Statement of

DR. ELIHU BERGMAN, EXECUTIVE DIRECTOR
AMERICANS FOR ENERGY INDEPENDENCE
Washington, D.C.

Submitted to the
Senate Finance Committee

April 21, 1986

Thank you Mr. Chairman for the invitation to present our views on proposals the Committee is considering to revise the excise tax treatment of energy resources.

Americans For Energy Independence is an organization, based in Washington, that performs educational work in the energy policy sector. We identify issues that involve the role of energy in the economic health and national security of the country, and promote informed discussion of them. In doing so, we represent no particular interest. We enjoy the luxury of applying a single yardstick in selecting and measuring issues: Is it good for the country?

We recognize that energy tax proposals are in the spotlight today as instruments for deficit reduction and revenue enhancement; not energy security. Whatever potential they have for those urgent objectives, we view them as issues of energy policy, and will discuss them from that perspective. We are concerned about what your decisions will do for the energy future of the nation.

In doing so, we do not propose to assess the potential of the various formulations; that is for you to do. However, we have taken the position for several years that some form of levy on imported oil would enhance the energy security of the country. That is still where we are coming from today, and with even greater urgency.

That urgency is being obscured in the euphoric afterglow of the oil price collapse, and the anticipation of the good economic news that will come in its wake. There is general agreement that the economic vital signs will improve at a faster rate in this country--except for its oil producing regions--and for the world as a whole--except for the oil producing countries. This profile of economic good health includes higher economic growth rates; lower interest rates; lower rates of inflation; and higher rates of employment. It is a tempting vision that compensates for the economic pain and frustrations past decade when whopping oil price increases determined by others savaged our economy. And we are told there is more good economic news to come, as oil prices continue to decline, or even if they remain at current levels--provided public policymaking does not interfere with the natural economic processes.

Unfortunately this is a short-sighted version of the reality. The oil outlook for the United States is not encouraging; oil remains the weak link in our energy system--despite the lower prices and our reduced levels of consumption and imports. And if we fail now to employ public policy to compensate for market signals that tell us to buy more cheap oil, we would forfeit our energy gains of the past decade, our present market advantage, and the opportunity once-and-for-all to become masters of our energy future.

Here are some of the components of our continuing vulnerability:

On the supply side:

There have been no major new oil discoveries in the United States since Prudhoe Bay, despite costly efforts by major oil companies to find more oil.

In 1985 there were two projections of future U.S. production by the Department of Interior's Geological Survey and the Congressional Research Service--both respected sources--that forecast a decline of as much as 50% in the 1990s. At current rates of U.S. oil consumption, even if they do not rise, this decline would require an offset of imported oil in the range of 4 million barrels a day.

There have been no major oil finds capable of production in the early 1990s outside of the countries that now have proven oil reserves. More than half of the world's proven reserves--oil that can be pumped out of the ground now--are on the Persian Gulf, held by OPEC countries.

On the demand side:

Nobody really knows how much lower oil prices will restore oil's popularity. We can assume that the equipment designed to use oil more efficiently, and to replace it, in the industrial, transportation, and household systems will not be abandoned. And the economists tell us that oil is not a wholly elastic commodity. Still, lower oil prices will create some additional demand.

Here in the United States there is a potential to restore the use of an additional 3 million barrels of oil a day. There is an estimated equivalent of about 1 million barrels of dual-use capacity in the industrial sector; plants that have facilities that can switch from natural gas to oil by flicking a switch.

In addition, there is about 2 million barrels a day in electric generating capacity that has been retired over the past ten years by the new nuclear and coal electricity plants. With electricity demand rising, and little evidence of new nuclear and coal plant orders to meet it, the easiest recource for utility companies is to restart the retired oil plants, and at a short-term bargain.

This is the supply/demand potential of the United States alone--the loss of the 4 million barrels a day in supply; and the potential for a pickup of another 3 million barrels a day in demand. There is the rest of the world to consider. The industrial countries have made substantial gains in efficiencies and substitutions for oil; but lower prices could add to their oil demand. And while oil consumption in the industrial countries has declined during the past 10 years, it has been increasing in the Communist and Less Developed Countries. Given their lack of alternatives, and population pressures, this group of countries could add pressure to the available supply of oil in the world.

To illustrate with a single key region of the world: Earlier this month the Chairman of the International Energy Forum meeting in Tokyo forecast an 83% increase in overall energy consumption in Asia (Japan; China; and the ASEAN countries) by the year 2000. The oil component of this increase would involve an additional requirement of nearly 7 million barrels a day above today's levels. And again, there is only one sure supplier of last resort.

The United States has reached another crossroads in national energy policy. The choices we make now in response to a glutted oil market and falling prices will be critical determinants of our future energy and economic security. We can respond to market signals, buy cheap oil, and enjoy all at once the improvement it creates in our economic vital signs. We can squander the advantage now. Or we can choose to conserve and preserve the advantage; to stretch it out; to make it a permanent fixture; by resisting the temptation for instant gratification. It is like the winner of a lottery spending it all now, or investing the windfall for the future. And it is abundantly clear that this streak of good fortune we now have won will fade away in the 90s if we fail to conserve and protect it.

With these real and dangerous prospects ahead, the national interest requires a set of energy policies focused on the continuing reduction of oil consumption. To reduce our vulnerability to insecure foreign sources of supply and price manipulation by unfriendly foreign producers, the United States needs to create a ceiling on our oil consumption that will prevent an increase in imports. With the real prospect of declining domestic production, this target requires policies that raise the cost of oil consumption to discourage its use and to maintain the value of substitutes for it. Regrettably, this goal cannot now be achieved by allowing the fine invisible hand of the marketplace to work its will; the fine invisible hand tilts toward more, not less, oil consumption.

To compensate for these wrong and dangerous marketplace signals, we need public policy to tilt the balance. A tax and tariff on imported oil and oil products; an adjustment in domestic taxes to capture any windfalls that might result from increasing the price of oil that originates abroad; an increase in the tax on gasoline; and the provision of tax incentives to restore domestic oil production are all measures we should consider. None of these actions will win political popularity contests; they will be tough to sell and digest. But they represent a partial premium payment on an insurance policy that could provide national energy security. And we must take out the policy now; before it is once again too late.

Thank you for the opportunity to express our views.

Senator CHAFEE. Senator Long.

Senator LONG. Have all the witnesses made their statements?

Senator CHAFEE. Yes.

Senator LONG. Has Mr. Bergman made his statement?

Mr. MORELLI. Yes, Senator, he did.

The CHAIRMAN. Yes, he did.

Senator LONG. Let me just ask Mr. DiBona this. How would you suggest we go about trying to maintain the maximum degree of energy independence, that we can here in this country, so that, in the event our supply and the free world's supply was cut off from the Persian Gulf, or interrupted by a conventional type war, how would you recommend if you have ideas on that, the best way for us to go to try, and maintain as high a degree of energy independence as possible?

Mr. DIBONA. I think it is a real problem because I do believe that, if the price stays low, it will be a relatively few years, before our imports are up at 50 percent of our consumption, and there will be a time when there will not be much spare capacity in the world.

So, dealing with this problem now is an important thing. It is a cyclical industry, and we are in one cycle; but it will swing back and that period, I believe, will be under 5 years, at prices like $15 or below. It is not an easy problem to deal with. There are a number of things that you can think of doing immediately, that would be helpful. One of them would be to eliminate the windfall profits tax. Even though it currently is not being paid, it enters into people's calculations about the future because, if they anticipate any price rise, they would have to take into account the fact that most of it would be taken in tax.

So, a first step would be to eliminate the windfall profits tax, because it is taken into people's calculations about the future. Another step would be other aspects of taxation on the petroleum industry, that is things that you have been discussing but are quite different, say, in the Senate bill—or in the House bill, rather, H.R. 3838, with regard to depletion and IDC's.

A third thing would be to make the best areas available, on public lands in the Outer Continental Shelf, that is the superior tracts; not take the view that because there will be less activity, we need not out up good tracts, but take the view that we are going to badly need the oil, when that might be available. And only the good tracts are going to be the ones that are going to merit investment.

Another thing would be to fill the Strategic Petroleum Reserve; that makes a lot of sense. And at a reasonably faster rate, because the price is low, and that would increase demand. And in that way, it would not only give us a cushion in the future, but also tend to very modestly increase incentives here. There are other possibilities, which the API is currently reviewing; and we hope to be able to come forward in the near future with other things.

There have been proposals, for example, to use the windfall profits tax that has been paid in the past, as a method of inducing production now. It was used to cut off the peaks, and it might be used in the troughs; but that is the sort of thing we are currently reviewing, and we should shortly have some specific posture on it.

Senator **Long**. What bothers me is that, under the existing economic facts of life, we are draining the fields that we have, and it is not economic. I know in my part of the world, it is not economic to go out and look for new reserves of oil and gas. So, the wildcat wells are not being discovered; wells are not being drilled.

You are just draining the wells that are there, and minus any major change in Government policy, that is what is going to continue to happen. And I take it that, that would mean that our degree of energy vulnerability, will go steadily up with what is happening right now.

Mr. **DiBona**. That is absolutely correct.

Senator **Long**. Every month it will be worse than it was the month before.

Mr. **DiBona**. That is right. The clear evidence of that is already in the drilling statistics. In 1981, we had 4,500 rigs going; we were just about keeping U.S. production steady. At the beginning of this year, we had 2,000 rigs going. The last figure I saw was 917 rigs; and that is the lowest point that we have seen since 1971, which is the lowest point since World War II, and 2 years before the first crisis.

Senator **Long**. Thank you.

The **Chairman**. Senator Pryor.

Senator **Pryor**. Thank you, Mr. Chairman. Mr. Donohue, in your testimony I believe you said something like this—I can't go to the page—you said "All costs or all additional costs," and I assume you meant taxes, "would be paid ultimately by the consumer."

Now, I tried to get a figure this morning from Secretary Mentz, and I finally got a figure. I don't agree with that figure. I imagine that the trucking industry in this country, carries more food to the grocery stores, and the markets, than any other part of our transportation system.

About 8 percent of the cost of that food in the grocery store, is attributable directly, or indirectly to transportation costs. Do you have any studies available to you, sir, that might indicate a true reflection, of how much food prices would go up to the consumer, given that set of circumstances, if this proposal on excise taxes took place, if it were passed?

Mr. **Donohue**. I don't have a definitive figure, as the Secretary didn't. He suggested, I believe, at one time one-half of 1 percent.

Senator **Pryor**. I believe that is correct.

Mr. **Donohue**. Which would have a very significant effect on the COLA in the United States, the payments we would have to make because of the Consumer Price Index. I would simply say that, as I indicated, I think eventually all the costs will go to the consumer either in increased prices or lost jobs or other factors. It initially will have a tremendous effect on the trucking industry.

If, in fact, 8 percent is the percentage on food, and that is correct, and if you recognize that the margins in the food industry are probably the tightest of any major industry in this country, any movement at all against their cost picture puts a significant movement against their price fixture. And I wouldn't argue with the question of one-half a percent or 1 percent.

The fact is that transportation in this country is essential to the conduct of any industry. It is 20 percent of the Nation's economy.

It consumes 62 or 63 percent of the Nation's fuel. And when you put a burden such as we are discussing—and by the way, that is a two-part burden—it is not only a lack of deductibility, which amounts to $3 billion before you pass it on, and that is equal to all of the profits of the whole for hire industry in trucking in 1985. So, when you figure the essentiality of this industry, the part that it plays in supporting—whether it be food or whatever—and you take first the loss of deductibility and, second, you take the indexing—and we all agree—Mr. DiBona and everybody in this room will agree—that at some point certainly very soon oil prices are going to move up at least some.

And that immediately is an increase again in our excise taxes and in the competitive position that we are in, we cannot immediately pass them on. When we do—and they will be—it will be a significant effect on the economy. What I am concerned about, above and beyond all this, Senator, is maintaining a capacity to move our goods and services and to support our national defense. Half a percent is a low number. Anything I can get for you, I will.

Senator PRYOR. Thank you.

Now, on this same line of food costs, Mr. Morelli, in our barge system we transport an awful lot of our grain from our farmers out to export markets and so forth using our barges and whatever, to get them to the ports.

Let's say if we could not deduct the excise tax as proposed by the staff here, what would that do to the cost of grain that we were shipping by barge? Do we have any sort of a ballpark figure on that?

Mr. MORELLI. Senator, I don't have those figures with me. There have been studies done. I will be happy to submit them for the record.

[The information follows:]

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May 16, 1986

Statement of The American Waterways Operators, Inc.
Supplement to the April 21, 1986
Finance Committee Hearing on the
Chairman's Excise Tax Proposal
(Submitted for the record at the request of Senator David Pryor)

In response to Sen. Pryor's inquiry, The American Waterways Operators, Inc. (AWO) would like to enter into the hearing record an excerpt of a 1983 study conducted for the Department of Agriculture by Dr. Gilbert Mathis entitled "Potential Impact of the Inland Waterway Fuel Tax on the U.S. Grain Industry." One of the principal findings of this study shows that grain producers have the least ability to pass on the burden of waterway fuel excise taxes.

It is important to note that, at the time of Dr. Mathis' study, the inland barge and towing industry was in the first few years of an economic depression from which it has not recovered. The grain-hauling segment of this industry has been hit the hardest, with numerous bankruptcies occuring since 1983. Over one-third of the inland hopper barge fleet is idle and tied to the river banks. Grain rates are at an all-time low.

Dr. Mathis' Summary and Conclusions follow:

The Barge and Towing Industry Association

Excerpt from "Potential Impact of the
Inland Waterway Fuel Tax on the U.S. Grain Industry"
Prepared by Dr. Gilbert Mathis for the U.S.
Department of Agriculture, 1983

SECTION V

SUMMARY AND CONCLUSIONS

The Inland Waterway Revenue Act of 1978 introduced a fuel tax on commercial users of the inland waterways. The tax, which was scheduled to reach ten cents a gallon by 1985, was designed to introduce self-financing for the construction and maintenance of the U.S. waterway system. Since 1981, other waterway user fee proposals have emerged which would significantly increase waterway user taxes beyond the levels specified by the 1978 law.

The primary purpose of this study was to examine the potential impact of imposing higher waterway user charges, levied as a tax on marine fuel, on various actors in the grain export production/distribution chain. In general terms, the study was concerned with the economic problems associated with the politically-charged question of who ought to pay for the improvement, operation and maintenance of the inland waterways. The specific focus was on the principle of intraindustry equity and was only proliferally concerned with questions of interindustry or intermodal equity. The larger issues relevant to the potential impact of the waterway fuel tax, or other types of user fees, on other agricultural or nonagricultural industries were addressed only as they related to the issues of intraindustry equity.

The study incorporated three major analysis activities: First, a profile of the U.S. grain export marketing system was developed to provide a theoretical frame of reference for modeling the potential impact of a marine fuel tax on the primary participants in the U.S. grain export production/distribution chain. Second, a disaggregated case study of two, independent, river-based Mid-Mississippi River region grain elevator firms was made to measure the potential impact of increasing the waterway fuel tax. Employing an *ex ante* proxy methdology, the case study analyzed the impact of changes in the price of fuel and other factors on the pricing of grain (corn) and waterway shipping costs for the period 1972-1981. Third, a survey was made of major U.S. grain exporters, independent barge and towing companies which transport export grain on the Mississippi River, and independent, river-based elevator firms which buy grain (corn) from farmers and ship it to New Orleans ports for export abroad. The survey was designed to obtain the perceptions of experienced grain industry representatives concerning the probable impact of rising waterway transport costs.

An examination of the characteristics of the U.S. grain export marketing system led to the postulate that grain producers have comparatively less capacity than other participants in the grain production/marketing chain to shift the burden of a waterway fuel tax to others. Consequently, grain farmers tend, in the long run, to pay a substantial porportion of waterway user taxes by being forced to accept lower cash bids for their corn at grain marketing terminals.

To test the postulate derived from the grain industry profile, an ex ante analysis of the case study elevator firms was designed. In an effort to reduce any potential analysis distortions associated with intrafirm subsidies, the case study was restricted to independent, river-based elevator firms that bought grain (corn) from farmers and, using the carrier services of independent barge and towing firms, shipped the grain to New Orleans for export.

For the purpose of the case study, marine fuel price changes were assumed to be an adequate proxy for assessing the potential impact of increasing waterway fuel taxes. It was recognized that a fuel tax imposed on commercial carriers on the inland waterways would not have exactly the same multi-modal effects as an increase in fuel prices. However, an increase in the price of fuel caused by a tax, or other reasons, can be expected to impose additional costs on the barge and towing industry which will be partially or totally absorbed or passed to others in the grain production/distribution chain.

The Mississippi River was chosen for this study because more than half of the total U.S. corn exports move from Mississippi River ports. The Mississippi River is also a relatively low cost waterway in terms of cost per ton-mile of traffic for both operation and maintenance and the cost of moving commodities. Any impact that higher fuel costs would have on moving commodities on the Mississippi River should be of equal or greater magnitude on higher cost waterways. Corn was selected as the focal grain commodity because corn represented approximately three-fifths of the total wheat, corn, and soybean exports moving from Mississippi River ports during 1981. Therefore, it was assumed that corn movements on the Mississippi River would serve as a good proxy of the minimum impact that increasing fuel cost would have on grain producers whose grain can be shipped on the inland waterway system.

The analytical tools of indexing, correlation and regression were used to examine the following case study relationships.

1. Corn prices at the two case study elevator firms.
2. Corn prices at Chicago and New Orleans.
3. Prices paid to independent barge and towing firms for shipping corn to New Orleans ports from the two case study elevator firms.
4. Changes in marine fuel prices to:
    a) the cost of shipping corn to New Orleans ports;
    b) the difference between average local cash prices paid to corn producers by case study elevators and the Chicago nearby futures prices (Chicago basis);

   c) the differences between average local cash prices paid to corn producers by the two case study elevators and the price of corn at New Orleans.

5. Changes in the quantity of U.S. corn exports to:

   a) changes in the cost of shipping corn to New Orleans;

   b) changes in the Chicago basis price of corn for the two case study elevators;

   c) changes in the New Orleans price of corn for the two case study elevators.

6. Changes in the supply of dry cargo barges and scows to:

   a) changes in the cost of shipping corn to New Orleans;

   b) changes in the Chicago basis price of corn for the two case study elevators;

   c) changes in the New Orleans price of corn for the two case study elevators.

7. Changes in the total ton-miles of cargo shipped on the Mississippi River to:

   a) changes in the cost of shipping corn to New Orleans;

   b) changes in the Chicago basis price of corn for the two case study elevators;

   c) changes in the New Orleans price of corn for the two case study elevators.

The analysis generated the following major results:

1. The prices of corn at the two case study elevator firms were highly correlated, which suggests that the prices paid to farmers for corn by the case study elevators are highly competitive.
2. The Chicago nearby futures prices of corn and the prices of corn at New Orleans were highly correlated suggesting those two major markets tended to move in concert.
3. The prices paid to barge and towing firms for shipping corn to New Orleans ports were highly correlated indicating substantial competition for waterborne shipping services.

These findings were also supported by data elicited through the industry surveys and the findings are consistent with the market structure characteristics of the corn export industry.

4. Changes in marine fuel prices were strongly correlated with:
    a) Changes in the cost of shipping corn to New Orleans from the case study elevators;
    b) the differences between local cash prices paid to corn producers by the case study elevators and the Chicago nearby futures prices for corn (basis);

c) the differences between average local cash prices paid to corn producers by the case study elevators and the price of corn at New Orleans.

These findings support the postulate that a substantial proportion of any increased cost of shipping corn caused by an increase in the price of fuel or other inputs, will be shifted to corn producers.

5. Changes in quarterly U.S. corn exports were moderately correlated with changes in the cost of shipping corn to New Orleans. Changes in U.S. corn exports were weakly correlated with changes in the basis prices of the case study elevators (for both Chicago and New Orleans).
6. Changes in the supply of barges were weakly correlated with changes in shipping costs and basis prices.
7. Changes in ton-miles of cargo shipped on the Mississippi River were strongly correlated with changes in the cost of shipping corn to New Orleans (although the relationship was weaker than the one between changes in fuel prices and shipping costs). There was a weak correlation between changes in total ton-miles on the Mississippi River and basis prices.

The relatively lower correlations for exports, barge supply and ton-mile variables (5-7) reinforce the findings that changes in fuel prices, which account for half of the cost of shipping corn on the inland waterways, explain approximately half of the changes in the cost of shipping corn and nearly half of the changes in local elevator basis prices.

The findings from the statistical analysis were also supported by information derived through the surveys of independent grain elevators, independent barge and towing firms, and major grain exporters. A high percentage of the representatives of all firms surveyed indicated that increasing the cost of shipping corn would result in long-run economic disadvantages for corn producers. Survey respondents representing major grain exporters and independent elevators agreed that an increase in the cost of transporting corn on the inland waterways would tend to widen the spread between the Chicago nearby futures price and the local cash price paid producers for corn. A high percentage of the respondents representing independent barge and towing firms also stated that they would attempt to pass the largest portion of any increase in the cost of shipping corn on the inland waterways to others.

In an attempt to determine how quickly rising waterway costs would impact corn producers, the data relating to the cost of shipping corn by independent barges to New Orleans, the local cash price of corn, the Chicago nearby futures prices of corn and the price of corn at New Orleans were all lagged one year with respect to changes in marine fuel prices. The result from this analysis indicated that changes in fuel prices were immediately associated with changes in the cost of shipping corn to New Orleans and to changes in the basis price (for both Chicago and New Orleans markets). These findings suggest that not only are fuel price increases passed along but that they are passed along in the short run. These findings were also supported by the survey data. A high percentage of the major corn exporters and the representatives of independent elevators stated that any impact of increased inland waterway transportation cost on the local cash bids for farmers' corn would be immediate.

The pricing data were also adjusted for changes in the consumer price index to determine if the various grain industry actors responded to real or nominal changes in the price of fuel, corn, and the price of shipping corn to New Orleans. The results of the analysis indicated that nominal price changes were the parameters influencing all the actors in the grain export marketing chain. Although this question was not addressed in the industry survey, inferences drawn from the profile of the corn export marketing system support the analysis result that producers, haulers, and exporters respond to nominal prices.

* * *

On the surface, the problems related to waterway user charges are seemingly not complex nor difficult to remedy because they do not involve insurmountable physical, technological, environmental or economic obstacles. However, closer scrutiny reveals that the waterway user charge issue consists of several essentially unique problem sets which are without a single policy solution that does not generate additional problems. Thus anticipated private or public solutions are frequently transformed into a search for policy resolutions which will effect a balance of allocative efficiency, financial and allocative equity and political feasibility. Although the primary objective of this research was estimating the potential impact that waterway user fees, levied as a tax on marine fuel, would have on corn producers, a number of unresolved waterway user-charge issues emerged during the course of the research. While beyond the bounds of this study, the following questions merit further analytical and policy consideration.

Although this study was purposely limited to the impact of a waterway fuel tax on corn producers, the results suggest that a waterway fuel tax would have similar impacts on other grain producers who are dependent on the inland waterways. Higher prices for waterborne farm production inputs, such as fertilizer and chemicals, would also result from increased waterway user fees and would disporportionately impact farmers.

Another important question relates to the effect that waterway user fees would have on the competitive structure of industries within the grain production marketing chain. How will increased waterway transportation costs impact independent grain elevators, barge and towing firms and farmers? What will be the impact of increased waterway transport costs on the number of firms in the grain marketing and transporting industries and ultimately on the degree of competition in those industries?

Given this nation's uniquely balanced transportation triad which provides efficient grain transporting services, what will be the response of non-waterway transportation modes to increased waterway rates? If barge rates increase because of user fees will the railroad and truck modes respond by stabilizing their rates and thus increasing their market share or will rates follow their historic pattern and increase as waterway rates rise? What are the market structure and overall economic consequences of either action?

Among the questions which surface when cost recovery user fees are levied are the type of user fee to be imposed and the appropriate amount of the charges. While a system-wide charge can be designed to provide for the cost recovery of navigation facilities, such a tax mechanism would not provide a market test to determine what facilities should be constructed, enlarged or abandoned. A segmented charge could provide a better market test but could also drive all the traffic off a waterway and permit no return to the fixed investment; further, a segmented charge could prevent relatively new waterways from developing. Navigation facilities and services often benefit those other than commercial users of the inland waterways. In such cases the problem of measuring and recovering these externalities emerges.

A broader issue relates to the impact of waterway user fees on different regions of the country and on the national economy as a whole. How will increased user fees affect jobs in primary water-dependent industries and the economy of the impacted region? What will be the effect of higher user fees on the prices of goods, raw materials and utilities? To the extent that low cost transportation contributes to the comparative advantage some U.S. products have in export markets, what will be the impact of user charges on the U.S. trade balance and, thus, on the national economy?

While this study may have done more to reveal the potential complexities of waterway user-charge issues than make policy choices easier, the analysis, has hopefully, widened the area of informed judgment and provided additional information regarding the issues which will ultimately confront policy makers.

Mr. MORELLI. I do know that as you have an increase in the cost of either the taxes or the barge rate, you have a significant effect on the export grain market; and it either results in diverting barge traffic to rail and eliminating barge competition would then boost the rail rates.

Senator PRYOR. But you would conclude—and I don't want to put words in your mouth—that it would make us less, rather than more, competitive, let's say, in the grain market?

Mr. MORELLI. Yes, Senator.

Senator PRYOR. And one final question to Mr. DiBona. I was intrigued by this—and it is something frankly that I have not thought of, and I will bet other members of the committee have—but on page 19 of your statement, Mr. DiBona, you talk about revenues raised by the Federal excise taxes on gasoline and diesel are going into the Highway Trust Fund, which is for our infrastructure, our highway work, repair of bridges, et cetera.

What effect would this proposal have on the ultimate balance of that trust fund and the amount of money that we pay into it each year?

Mr. DIBONA. To the extent that the tax was simply raised by essentially 4 or 5 cents, which is the effect of this on the consumer, it would still move approximately the same amount of money into the Highway Trust Fund. It would simply mean that all these additional revenues would be going into the general fund, rather than into the Highway Trust Fund, which has been the traditional use of this.

So, our concern is that it is a regressive form of taxation used to reduce the problem of the general revenue shortfall, rather than using it for the specific purpose.

Senator MITCHELL. Thank you, Mr. Chairman. That is all the time I have on this.

The CHAIRMAN. Mr. DiBona, do you agree with Mr. Donohue—or at least that is what I sense Senator Pryor was saying—that eventually all costs, all taxes, are passed on to consumers, anyway?

Mr. DIBONA. I don't know what you want to call a consumer. I mean you have to ask the question whether the owners of capital and the suppliers of labor are technically called consumers because the way this thing would work——

The CHAIRMAN. I mean consumers as the ultimate purchasers of the product.

Mr. DIBONA. I don't entirely agree with that. No. I think it will spread among all of them. In the case of petroleum, for example, the price elasticity of the demand for gasoline is quite low in the short run and fairly high in the longer run. So, the first impact would be that the price would rise the full 5 cents; but simultaneously, the demand will fall slightly. Over time, it will fall by a bigger amount. That means that, over time, there will be a smaller amount of employment in the petroleum industry than there would otherwise have been, and the capital will be underemployed; and therefore the return on capital will drop. So, shareholders in the petroleum industry will be less well off.

The employment in the petroleum industry will fall, and therefore workers in the petroleum industry will be less well off; and the consumer will pay more.

The CHAIRMAN. I am not asking my question right. What difference does it make then? Costs placed upon the petroleum industry—whether they be excise taxes, withholding taxes, the minimum wage times three, or whatever you might want to require—you are saying some of those will be passed on. Some of them will be absorbed by the capital shareholders. Does it matter what kind of cost is imposed upon the industry vis-a-vis what is passed on?

The argument is that the excise tax is passed on, but in your particular case, with the windfall profits tax, it isn't. To a business what difference does it make whether it is a State real property tax, a Federal excise tax, or the FICA taxes? They will pass them on if they can; and if they can't, they have to digest them among different portions of their corporate structure somehow.

Mr. DIBONA. It does matter whether or not, for example, they are imposed on foreigners.

The CHAIRMAN. Oh, I understand.

Mr. DIBONA. So, it does depend on whether or not the competitors of the petroleum industry are subject to the same taxation.

The CHAIRMAN. I understand that.

Mr. DIBONA. So, that is an impact. It also depends—I mean, some of these taxes have traditionally had specific uses. So, from the standpoint of the petroleum industry, one might say it is a matter of indifference; but from the standpoint of the Nation, it might be different. That is, to the extent that you impose these taxes on consumers of gasoline, people generally think that is regressive, at least on the consumption side.

But if it is, in fact, a user fee, it tends to improve the conditions of the roads which they use, then that would be a different thing than if you used the money, because it is collected under a different heading, for some other purpose. So, I am suggesting that the effect on the oil industry is not the only consideration that I was raising.

The CHAIRMAN. Mr. Donohue, absent your competition with the railroads—and, in most cases you don't go head to head with the railroads—if additional costs were imposed upon you, why can't you simply pass those along through the collective ratemaking process?

Mr. DONOHUE. First of all, Senator, let me just say that more and more now with the double-stacked trains and the east-to-west hauling, in some segments of our business, we are going to run head to head with the railroads more than we have. You will also remember that in the matter of the collective ratemaking issue, that only affects for the most part, the less-than-truckload business.

And when you look at the truckload business, which predictably hauls food, for example, and bulk commodities and when you look at the leasing business and you look at the special commodities people and you look at the private carriers—all of whom make up some 70 percent or more of the business—they don't use and have the benefit on a regular basis of the collective ratemaking system.

So, they don't have the facility to pass it on.

Let me also say that in that particular segment of the business, that is where we have had the major increase in competition and a significant drop in the price of the product or the service. So, we would have a very hard time initially passing that on.

I happen to believe, from an economic point of view, that all costs eventually get passed on; but wether they end up with the consumer who pays a larger price or the worker who gets a smaller salary or the contractor who sells fewer trucks to us, for the economy to work out.

The CHAIRMAN. If they all get passed along, then from the standpoint of efficiency, why don't we levy all of our taxes on businesses, which reduces our collection spots tremendously; and they will get passed on as the economy directs?

Mr. DONOHUE. I think, Senator, we have demonstrated over history that we use the tax system here to encourage certain factors in our economy. We have been at this now for a couple of weeks. The same thing has been going on here, and the various different industries as they make their case as we are attempting to do now; and what we are saying is that if you were to put all the costs and all the taxes in this country on business and ask them to pass it on—responding to your question—it may be more efficient.

It certainly would not be very sympathetic to declining and problem industries; and it might bring some chaos to the system. And I don't know that we are going to do that.

One of the things we are doing in this tax reform, which as you know, we have initially supported, is we are trying to take taxes away from the individual; and then we are trying to find companies and industries that we can tax so that they will go back and collect them from the individuals.

And I think we need to find some balance here. What we are saying in this industry—and speaking in terms of excise taxes that it will be regressive, which we all pretty much agree to, and the other thing is that from our industry, we can't pass it on immediately. It is going to be a significant trauma in an industry that is in very serious trouble right now.

The CHAIRMAN. Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman. Being the last to ask questions, I have had many of my questions answered; and I think Mr. Donohue hit a point there which was a question which was raised in my mind.

But I might ask this: Since the excise taxes in the Federal system are not applied uniformly, but highly selectively, what about the argument that those who do not pay or are now allowed to deduct the excise tax—well, you represent an industry which does—but the others are expected to pass it on to the customers.

How would you answer the argument that eliminating the deductibility of excise taxes would make the taxes more uniform?

Mr. DONOHUE. At present, Senator, my understanding—and I am learning more about this all the time—but my understanding is that all excise taxes at the present are deductible as a normal course of doing business, as a business expenditure, as with any of the other expenses I enumerated before. Of course, we have some inequities.

For example, in the transportation business where the railroad do not pay any excise taxes at all on fuel or on equipment, except on the piggyback trailers, that creates an inequity and a disincentive to competition.

Now, if we go and we follow the proposal of the committee and we eliminate the deductibility of those excise taxes, a number of things happen. First of all, the railroads get a double bounce; they are ahead twice—once because they don't have them and once because they don't lose the deductibility of them. And the other thing is that you find that you have got three or four problems.

First, you are eliminating a system of deductibility that has been historic, and wonder what comes next. Second, when you are talking about indexing those excise taxes to prices that we absolutely know are going to go up, you are building in an immediate increase. And third, you are putting them on an industry that is in some serious difficulty at this time—much of it is the making of economic phenomenons—and you are saying that we are going to hasten and exacerbate the economic consolidation ald fallout in that industry. It is a very serious matter.

But as I understand it, now all the taxes are deductible. They will not be afterward; and what that will do is create inequities amongst industries and particularly competitive inequities in the transportation business.

Senator MATSUNAGA. Mr. Bergman, I was happy to find that Americans for Energy Independence is represented here today; but I note that in your testimony you propose that some form of levy on imported oil be placed, that it would enhance the energy security of the country. Would you say this even in, say, the face of rising oil prices? The trend now is down, and you say there is an even greater urgency now.

But suppose the prices are going up instead of down? Would you make the same proposal?

Mr. BERGMAN. What I did was I left that decision to you. There have been some proposals here that would impose sort of a variable tariff. The tariff or the tax would disappear as the price rose again. I didn't presume to define exactly what the trigger price would be.

Our point is that there should be incentives both on the supply side to encourage oil production in this country and incentives on the demand side to discourage oil consumption; and this is why, as one of the options, we recommended the possibility of an oil import tax.

And of course, we recommend the possibility of a gasoline tax, as well. Among other attractions, a 50-cent-a-gallon gasoline tax would raise $50 billion in revenues, and that would seem to be fairy attractive in today's circumstances.

Senator MATSUNAGA. Being a champion of alternative energy development myself, as you may know, I am somewhat dismayed that there is no mention of providing incentives for alternative development.

Mr. BERGMAN. I think, Senator, that a tax on oil and gasoline indeed would serve that objective. One of the dangers to alternatives now, and I include all of them—the conventionals, conservation, and some of the nonconventionals like solar energy, wind power, and so forth—is that the decline in oil prices has removed much of the incentive to pursue them.

And as you know, a number of companies, say, in the solar energy business are abandoning it; similarly wind energy and some of the other things. Coal energy is threatened as well.

Senator **Matsunaga**. Largely on account of the termination of the energy tax credit as of December 31 last. Now, you are for extending the energy tax credits?

Mr. **Bergman**. Absolutely. I think it is like paying a very small but worthwhile insurance premium toward the energy security of this country.

Senator **Matsunaga**. My time has expired.

Mr. **Donohue**. Mr. Chairman, it is possible for me to make just one comment about that? Senator, just two very quick points about this. On a pass-on—on a 35-percent tax rate as being discussed here, we have to pass on 54 percent to get just even—that everybody is even. And I think it is important that we get carried away with percentages, but my colleague here is talking about very large fees—import fees or fees per gallon. When you start passing that down to the ultimate consumer, a $10-a-barrel import fee is 24 cents a gallon, and you will lose 300,000 jobs in this country when you do it. So, when you multiply that by 5, you had better be calculating very, very carefully which consumers are going to pay that and what effect it is going to have on this industry.

And we are not raising all kinds of noise about that. I am just saying we have to calculate in real terms what the end cost to the consumer is and what effect it will have on the industry.

The **Chairman**. Senator Chafee.

Senator **Chafee**. Thank you, Mr. Chairman. Mr. DiBona, isn't it possible if the price of oil rose so that the cost per barrel was once again subject to the windfall profits tax, that you could have a situation where, for every additional $1 of income, it would cost you $1.05?

Mr. **DiBona**. That is exactly correct, Senator.

Senator **Chafee**. Could you explain that?

Mr. **DiBona**. Yes.

Senator **Chafee**. I mean, in your testimony. I missed part of your testimony.

Mr. **DiBona**. Yes, sir; but I can explain it. It is very simple. You would pay for old oil 70 percent if you are an integrated company. So, if the price of the oil rose $1, you would pay 70 cents in windfall profits tax, which is an excise tax. It is independent of your profitability, just the price.

Senator **Chafee**. Right.

Mr. **DiBona**. But you would have had $1 of additional income. At the 35-percent rate, you would have a marginal tax of 35 cents. So, you would pay 70 cents plus 35 cents, or $1.05; and that is quite apart from any severance tax of the State and so forth that would be additional.

Senator **Chafee**. Even in Britain, when their rates get up, they allow the taxpayer a collection fee, don't they, of 5 percent or something? [Laughter.]

Mr. **DiBona**. I am not sure.

Senator **Chafee**. Now, let me ask a question of Mr. Scherder. Let's take an underground mining operation where the black lung tax is—what?—$1.10 per ton.

Mr. **Scherder**. Yes, sir.

Senator CHAFEE. So, in effect, what the mining company is doing is adding a charge of $1.10 to their tonnage in order to pay the black lung?

Mr. SCHERDER. That is correct.

Senator CHAFEE. Now, if that were not deductible, wouldn't we then have the situation where you would collect the extra $1.10 to pay the tax, and then you would be paying an income tax on the $1.10 you have collected?

Mr. SCHERDER. That is correct, and you would not, in many cases, be able to add that on to the price of your coal because we have many long- and medium-term coal supply agreements which don't allow for a passthrough on a Federal income tax increase. And in fact, with the state of the market today, even if you had a clause to pass it through, you probably couldn't do it; and you especially couldn't do it on your export sales.

Senator CHAFEE. Are you exporting much of anything?

Mr. SCHERDER. Our company exports between 5 and 10 percent of our sales, but the industry exports a lot of coal; and the market is extremely tough today.

Domestically, we are comoeting against, now, the low priced oil and some of the other energies; so even domestically, it would be very difficult.

Senator CHAFEE. Fine. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Further questions?

Senator LONG. I would like to ask Mr. DiBona if he would make this clear. If this tax went into effect—let's say the windfall profits tax triggered at $22—isn't that where it would be right about now?

Mr. DIBONA. It is about $18 now.

Senator LONG. I mean, would the tax trigger at $18 or at $22?

Mr. DIBONA. I think it is about $18 or $19.

Senator LONG. About $18?

Mr. DIBONA. Yes.

Senator LONG. Let's just take that figure. Suppose the tax would trigger at $18 if this nondeductibility were in effect. So, if someone offered you $19——

Mr. DIBONA. You wouldn't take it.

Senator LONG. You have to pay $1.05 additional taxes.

Mr. DIBONA. That is right.

Senator LONG. So, what you say is, "Let's forget about it. I would refuse to sell for anything over $18." Is that what you are saying?

Mr. DIBONA. Some mornings you would feel that way.

Senator LONG. That is right. Of course, he can buy the oil for the $18; and he could put it into a refinery then and run it on through, and he could make the extra dollar by the price of the gasoline or the eventual product.

But if you got $19, you would owe $1.05.

Mr. DIBONA. That is exactly right. If you were the producer, you would be very reluctant to take it because you have to pay the tax; but if a little further downstream—that is right.

Mr. DONOHUE. Don't forget that it is going to cost him more to ship it, now that we are passing that price down, too. [Laughter.]

Mr. DIBONA. It has some very pernicious effects.

Senator LONG. That kind of makes me think of some jokes I have heard from time to time——

[Laughter.]

The CHAIRMAN. Any other questions?

[No response.]

The CHAIRMAN. If not, gentlemen, thank you very much.

Now, we will take Mr. Robert Dickemper and Mr. Paul Ignatius.

If I might say just a word about Mr. Ignatius, I don't know if you will be before us again or not. He is retiring after 14 years as head of the Air Transport Association, and with 26 years in Federal service before that. You have been before this committee many, many times and have always been a fair and intelligent witness; and I, for one, hope that when you retire from the Air Transport Association, you will find something else that will cause you to come here from time to time.

Mr. IGNATIUS. Thank you very much, Mr. Chairman. Anything I say after this will be an anticlimax, but thank you very much. I very much appreciate that.

The CHAIRMAN. Go right ahead.

Mr. IGNATIUS. If you want me to go first, I will.

The CHAIRMAN. Oh, let's take you in the order you appear, and we will go with Mr. Dickemper first.

Mr. IGNATIUS. All right.

STATEMENT OF ROBERT A. DICKEMPER, VICE PRESIDENT, GOVERNMENT AND INDEPENDENT AFFAIRS, SOUTHWESTERN BELL, WASHINGTON, DC, ON BEHALF OF THE UNITED STATES TELEPHONE ASSOCIATION

Mr. DICKEMPER. Thank you, Mr. Chairman and members of the committee. My name is Bob Dickemper, and I am vice president, government and industry affairs, for Southwestern Bell Corp. I also serve as chairman of the United States Telephone Association [USTA], Government Relations Committee. I am addressing the committee today on behalf of the USTA and its more than 1,100 member companies that provide local exchange telephone services to customers throughout the country.

The breakup of the Bell System, the resultant creation of 7 new regional companies, and the emergence of deregulated competitors has created a new and highly competitive environment for these 1,100 companies, their employees, their stockholders, and customers.

On behalf of the industry, I must commend the chairman and the committee for their insight in recognizing this new environment. Your understanding of the challenges faced by regulated local telephone companies providing state of the art universal telephone service at a reasonable cost has resulted in a realistic depreciation schedule.

As you stated before this committee last week, Mr. Chairman, your proposal mandates equal treatment for comparable property to prevent putting regulated companies at a competitive disadvantage to nonregulated companies.

Last year the entire industry, local and long distance, collected Federal excise taxes of $2.3 billion on behalf of the Government. Currently, telephone companies merely act as agents in collecting these taxes from customers. The tax is not imposed on the provider, but the user of the service. Therefore, telephone companies do not include these amounts in taxable income or take a corresponding tax deduction. The staff proposal does two things to the telephone industry: One, it reverses a historic practice mandated by statute to impose the communications excise tax on the person paying for the services; and two, it would require inclusion of the tax in income and deny the corresponding deduction to the telephone companies for the payment to the Federal Government.

The effect would be to create taxable income from the temporary receipt of Government funds when no economic gain would be realized. If the staff proposal is intended to ensure that every dollar charged for excise taxes is actually collected by the Federal Government, the telephone industry already meets that goal. If, however, the proposal is only a mechanism to raise additional revenue, the provision changing the incidence of the communications excise tax does not accomplish that goal in an economically efficient manner.

Another problem the industry has with the excise tax is that it encourages bypass. While customers of regulated utilities are subject to the tax, those who install private communications systems are not subject to the tax. In fact, application of a tax on bypass facilities would be very difficult to administer and would require a different application than regulated industry.

In conclusion, Mr. Chairman, we encourage you and the committee to continue your demonstrated understanding of the new telecommunications environment by allowing the telephone industry to collect the excise tax from consumers and remit it on a dollar-for-dollar basis as we are doing today.

Thank you.

The CHAIRMAN. Thank you. Mr. Ignatius.

[The prepared written statement of Mr. Dickemper follows:]

TESTIMONY OF
ROBERT A. DICKEMPER
ON BEHALF OF THE
UNITED STATES TELEPHONE ASSSOCIATION

Good morning Mr. Chairman, Members of the Committee. My name is Bob Dickemper. I am Vice President--Government and Industry Affairs for Southwestern Bell Corporation. I also serve as Chairman of the United States Telephone Association (USTA) Government Relations Committee. I am addressing the Committee today on behalf of the USTA. The USTA is composed of more than 1,100 local telephone companies in the United States. In total, we represent 754,000 employees, 19 million stockholders, $196 billion in plant and $75 billion in revenues.

The telephone industry has changed dramatically in the last few years. The break up of AT&T has created seven new regional telephone companies. These companies and the other 1100 member companies of USTA provide local telephone exchange services to customers throughout the country. The member companies of USTA vary in size from the Curlew Telephone Company in Glen Ullen, N.D., which in 1985 served 13 rural residential customers to a company that serves as many as 15 million customers. The local exchange industry is unique in that it is both capital intensive and "high tech". It is a fundamental industry upon which all other American business depends.

Last year, the entire industry--local and long distance--collected federal excise taxes of $2.3 billion on behalf of the federal government. Currently, local telephone companies merely act as agents in collecting these taxes from customers. The tax is not imposed on the provider but the user of the service. Therefore, local telephone companies do not include these amounts in taxable income or take a corresponding tax deduction.

Chairman Packwood's proposal would shift the incidence of excise tax from the consumer to the telephone companies. In addition, the excise tax would be included in the gross income of the telephone companies and no deduction would be allowed when the taxes are paid to the government. The effect of the proposal would be to create taxable income from the receipt of government funds when no economic gain would be realized.

In my testimony today I would like to address:

--the history of excise taxes on communications services
--how the industry accounts for, collects and remits excise taxes
--the Chairman's proposal and how it relates to communications services.

HISTORY OF COMMUNICATIONS EXCISE TAX

In the 25 years since the Tax Rate Extension Act of 1959, there have been 10 separate proposals to phase out the excise tax on communications services. The consistent desire of the Congress to eliminate the application of the excise tax on communications has been driven by the undesirable and discriminatory characteristics of the tax. For example, in the Senate Finance Committee Report accompanying the Excise Tax Reduction Act of 1965, the Committee found:

> ...[T]he tax on local and toll telephone service and teletypewriter exchange service is undesirable as a permanent feature of our excise tax system. This conclusion was reached on the grounds, first, that these taxes are regressive and therefore fall with greater severity on those with low incomes than those with higher incomes. Second, the charges for telephone services enter heavily into business costs. Therefore, the tax discriminates against those firms that must make extensive use of the taxed services. (Senate Report No. 89-324, Excise Tax Reduction Act of 1965, June 14, 1965, pp. 34-35.) See, APPENDIX A for the History of Communications Excise Tax.

INDUSTRY ACCOUNTING FOR EXCISE TAX

The telephone industry collects, as agents for the federal government, excise tax on local and long distance telephone service. The tax is calculated monthly and appears as a separate line item on the telephone bill. The entire amount of tax collected is transferred to a special account and the proceeds of the account are remitted to the federal government. The communications tax account is a liability account and is not a part of a telephone company's profit and loss statement. The telephone excise tax is not brought into income by the telephone companies. The Communications Excise Tax Return, Form 720, is filed quarterly. The IRS may audit the returns and the collection process yearly.

The audit schedule is necessitated in part by certain exemptions that have been written into the law over the years. Exemptions cover the following customers and services:

Federal, State, and Local Governments
Collection and Dissemination of News
Radio
Television
Common Carriers
Private Communications Services
Foreign Governments
Consular Officers
Armed Forces in Combat Zones
Non-Profit Educational Institutions
Religious Schools
Non-Profit Hospitals
Community Action Programs of Economic Opportunity Program
Members of Congress
Coin-Operated Calls of less than 25 Cents

If the IRS determines that a customer has claimed an exemption without justification, the IRS is required to collect the tax from the customer that has claimed the exemption improperly.

The telephone industry has historically acted as a collection agent--collecting and remitting excise tax on a dollar for dollar basis. The industry has not taken excise tax revenue into income, which it would be forced to do under the Chairman's proposal.

IMPACT OF THE CHAIRMAN'S PROPOSAL

The Chairman's excise tax proposal does two things to the telephone industry: (1) it reverses an historic practice mandated by statute to impose the Communications Excise Tax on the "person paying for (the) services;" and (2) it would deny an income tax deduction to the telephone companies for the payment to the federal government of the excise taxes collected directly from customers.

Chairman Packwood has stated that this proposal is intended to ensure that every dollar charged for excise taxes is actually collected by the federal government. The telephone industry already meets that goal. If, on the other hand, the proposal is simply a mechanism to raise additional revenue, the provision changing the incidence of the Communications Excise Tax does not accomplish that goal in an economically efficient manner.

If the incidence were changed, and providers of telephone service--the telephone companies--instead of customers, are liable for the excise tax and the additional income tax expense caused by denial of the deduction, regulated local telephone companies would have to apply to their regulators not only for the additional revenues, but also for increases in rates to provide those revenues. The corresponding dilemma faced by both local telephone companies and their regulators would be in deciding how to equitably distribute the burden of the additional tax expense in an environment where the prices allowed to be charged by regulated companies may not related to the costs incurred.

In a regulated utility environment, the additional revenue burden caused by the proposal would have to be assumed by the average telephone subacriber. If the revenue burden were imposed evenly on all customers, for each dollar of revenue from excise tax taken in as income the effect of taxation at the proposed marginal rate of 35% would require the collection from ratepayers of $1.54.

The industry currently collects and remits the excise tax on a dollar for dollar basis and does so in proportion to the service provided to the customer. The Chairman's proposal would increase the cost of the excise tax to consumers and distort the basis of applying the tax to consumers.

Another problem that the industry has with the tax is that it encourages bypass. Bypass undermines the vitality of the local exchange business because customers move to unregualted alternatives, and reduce the inherent efficiency of a single network. While customers of regulated utilities are subject to the tax, those who install private communications systems are not subject to the tax. In fact, application of a tax on bypass facilities would be very difficult to administer and would require a different tax framework than regulated industry.

As a result of modern technology and deregulation, private parties can purchase their own telephone equipment and bypass the local exchange companies. Under present law the local exchange companies are required to collect the tax, but the non-regulated bypassers are not. Consequently, the private bypasser may have a lower cost of service because it does not have to pay the telephone excise tax. If the incidence of the tax is changed and a deduction for the tax is denied, the additional increased cost of service will be passed on to the customer. Whether the local telephone company, in fact, can shift the added tax burden depends on the demand and the supply of alternative telephone services in the community. To the extent that there are substitutes for the taxed telephone services which are not taxed or are taxed less, telephone customers have increased incentives to shift toward these services.

SUMMARY

The telephone excise tax is particularly unfair to local telephone companies and their subscribers:

(1) The tax is regressive because it falls more heavily on lower income groups and does not meet the needs of tax equity;

(2) The tax is imposed on a necessity used by most homes and businesses;

(3) Among four basic household utilities--electricity, gas, water, and telephone-- only telephone service is subject to a federal excise tax; and

(4) Businesses that provide their own communication services are not subject to the tax. An increase in cost will encourage further bypass.

If the providers of telephone service, instead of customers, were liable for the excise tax and the additional tax expense caused by denial of the deduction, regulated local telephone companies would have to apply to their regulators not only for the additional revenues, but also for increases in rates to provide those revenues.

The Committee should allow the local telephone industry to continue to collect the excise tax from consumers and remit it on a dollar-for-dollar basis. Additionally, at an appropriate time Congress should reexamine their historic objective of elimination of the tax on the communications industry.

APPENDIX A

HISTORY OF COMMUNICATIONS EXCISE TAX

The excise tax on communications services has been in place since 1914 with the exception of the periods from 1916-1917 and 1924-1932. In the early days, the tax was applied principally on long distance messages, telegraph messages, radio messages and leased wire services.

In 1941 local telephone service was added to the list of taxable services. During the World War II years, increased rates were levied with the intention of reducing the rates 6 months after the cessation of hostilities. However, the higher level of rates remained in effect until approval of the Excise Tax Reduction Act of 1954 when rates were reduced to 10% on local service, toll messages and leased wire services.

Technical changes to provide consistency of application were made in 1958 and, in 1959, The Tax Rate Extension Act provided that the tax on general telephone services would terminate on June 30, 1960. This was the first of several planned eliminations; however, similar to many of those that followed, the proposal was revoked before it went into effect.

The Excise Tax Reduction Act of 1965 provided for the phased elimination of the tax over a period from 1965 - 1969. The Tax Adjustment Act of 1966 subsequently repealed those rate reduction steps but made provision for the reduction of the 10% rate to 1% effective April 1, 1968 and termination of the tax on January 1, 1969.

This proposed elimination was altered by the Revenue Expenditures Control Act of 1968 which continued the 10% rate and established a schedule for elimination of the tax over a period from 1970 to 1973. This plan was modified by the Tax Reform Act of 1969 which left the basic plan intact but moved its effective dates out 1 year.

The Excise, Estate, and Gift Tax Adjustment Act of 1970 extended the 10 percent rate through 1972 and established a new phase out schedule of 1972 through 1982. This reduction was to be a 1% reduction per year for 10 years.

Reductions of 1% per year occured between 1973 and 1980. In 1980 the Omnibus Reconciliation Act delayed the termination process by 1 year and maintained a 2 percent tax rate for 1980 and 1981. The Economic Recovery Tax Act of 1981 again extended the expiration date through 1984.

The 1982 Tax Act raised the tax from 2% to 3% and continued the tax through 1985 and the 1984 Deficit Reduction Act extended the 3% tax rate through 1987.

STATEMENT OF PAUL R. IGNATIUS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AIR TRANSPORT ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. IGNATIUS. Mr. Chairman and members of the committee, I know my full statement will be made a part of the record; I will brief it quickly, and have three points that I want to make.

First, I want to talk just about the history of these airline excise taxes. Second, I want to discuss the proposal that the committee has under consideration. And third, I want to make one or two summary comments.

First, with respect to the history of this tax, it was first imposed in 1942 as a wartime measure. In 1962, the excise taxes on other forms of transportation were repealed, but were retained in the case of the airlines, with passengers and shippers paying the tax. In 1971, the taxes were set aside in the Aviation Trust Fund, the purpose of which was to meet the capital needs of the airways and the airport system. The taxes collected—the principal one being the 8 percent domestic ticket tax—flow into the trust fund from which the Congress authorizes and appropriates amounts for airport and airway needs.

In 1982, it was evident that we had need for a substantial expansion and modernization of the air traffic control system. That year, I was able to inform the administration that we would support an increase in those taxes from the 5-percent level—the tax rate at that time on domestic tickets—to an 8-percent level in order to fund this new multibillion dollar program to buy new computers and other equipment for the airways and to continue the aid to airports programs.

Now, today, we serve as we have historically served—in Senator Chafee's words this morning—as tax collectors. We collect these taxes; we remit them promptly to the Government; and the amount of these taxes that we collected in 1984 was on the order of about $2.4 billion. And I point out in my statement that, were the committee's proposal to be adopted, we would be paying as taxpayers more than the profit of our industry in 1984.

The proposal that the committee has before it would shift the tax burden from passengers and shippers to the airlines. The income from the tax would be taxable income; and as I say, in 1984 and indeed in 9 of the last 10 years, this new tax would have exceeded the industry's profits.

For those reasons, this is a matter of some considerable importance to us. The tax, in effect, is a gross receipts tax on us since we serve and have historically served as collectors for the Government.

Now, a final point. I was pleased to hear this morning some of the criteria that Secretary Mentz indicated that might be used for thinking about this. And he used the term "surrogate user tax," I believe. In the case of these aviation taxes, they are user taxes. They were recognized as such by the Congress when the taxes were set aside to form the Aviation Trust Fund.

I would hope the committee would look long and hard at the current system. I believe it works well. Our system of collecting taxes is relatively simple. The shift to making this taxable income would be a more complicated process; and finally, the amount of the tax would be a very substantial and significant tax as far as the airlines are concerned.

I thank you for this chance to appear, and I particularly thank you once again for your remarks at the outset.

The CHAIRMAN. Thank you. Senator Long.

[The prepared written statement of Mr. Ignatius follows:]

Statement of
Paul R. Ignatius, Chairman of the Board
Air Transport Association of America
Before the Committee on Finance
United States Senate
April 21, 1986

The Air Transport Association of America, whose members account for more than 90 percent of the revenue passenger miles flown by the U.S. airline industry, and who operate most of its cargo service, appreciates the opportunity to offer views on the discriminatory proposal to require the airlines to pay income tax on the transportation excise tax which they now collect from passengers and shippers for the government.

The Finance Committee proposal would increase the cost of air transportation and impose a substantial new tax upon the airlines. First, it would make the airlines, not passengers and shippers, the payers of the taxes. Additionally, it would treat the taxes collected as income to the airlines and impose a 35 percent tax on that "phantom income".

The proposal, in effect, imposes a gross receipts tax on domestic passenger revenue of the U.S. airlines. If it had been in effect in 1984, the proposal would have required the airlines to pay an additional tax of $860 million in a year where the industry's total profit was only $825 million. This should indicate to you, Mr. Chairman, why the airlines are so concerned about this proposal and why we are anxious to make our views known.

What was true in 1984 would have been equally true in most other years. Indeed, during the past ten years, airline profits exceeded the amount of the proposed new tax on only one occasion. Thus, with one quick stroke of a pen, the U.S. Government would earn more from the operations of the airlines than have their stockholders. Moreover, the treatment of the airlines would be discriminatory because they would be the only mode of public transportation so taxed.

The proposal would adversely affect the continued improvement of the nation's airports and airways to meet the growing demand for air transportation. This is because the new tax would be paid to the general fund, thus violating the commitment made by Congress and the Administration to use the proceeds from air transportation excise taxes solely to improve air transportation.

In 1942, excise taxes were first imposed as a wartime measure on passengers and shippers using all modes of transportation. In 1962, the tax on other modes of transportation was repealed, but the 5% tax on air transportation was continued to pay for the cost to the U.S. Government of the airway system.

In 1971, the air transportation tax was fully recognized by the Congress as a user fee. The Airport and Airway Trust Fund was created to ensure that the revenues from the user fee would be used only for improvements to the nation's system of airports and airways. The airlines fully supported this concept in hearings in both the Senate and House of Representatives.

In 1980, Congress failed to reauthorize the Airport and Airway Trust Fund and as a result the user fee reverted to pre-1971 percentage amounts. The user fee structure was reauthorized in 1982 at the higher levels previously in effect -- 8 percent on domestic passenger tickets, 5 percent on domestic cargo waybills, and a $3 charge for international passenger departures.

The airlines supported the reauthorization and the increase because of the federal government's promise to pursue vigorously the critically needed and expensive expansion and modernization of airports and the air traffic control system. The airlines recognized that additional revenues would be necessary and agreed that the user fee system was appropriate because the amounts collected were to be used exclusively for improving air transportation.

The airlines have served as tax collectors without compensation since the inception of the program, and have borne the burden of establishing and maintaining an efficient collection system. This responsibility has included the need to interpret changes in the law in the absence of any updating of IRS's pre-1971 regulations. The changes require, for example, the collection of the user fee from government entities, diplomats, and religious and charitable organizations, all of which were exempt under prior law.

The assessment and collection of the present user fees has a number of variations. For example, the domestic portion of an international journey is exempted, as is cargo for export. Flights between the mainland and Alaska and Hawaii, and between Alaska and Hawaii, are not fully taxed, but instead, are taxed upon a mileage proration. There are also special rules which apply to the imposition of the user fee on the carriage of the mail.

The airlines have been able to handle these and other exceptions because the collection and remittance system today is basically simple. The airlines are required simply to collect the required fees and remit them promptly to the government. Under the Committee's proposal, however, this simplicity of operation would have to give way to a complex and burdensome process. The reason for this is that each airline participating in a journey would have to be assessed for its respective portion of the proposed new tax, and the interline collection system would have to insure somehow that all parties involved were correctly handled. ATA estimates that some 40 million tickets would be involved in this new allocation process each year.

Our counsel has advised us that the proposed tax on phantom income would not be an income tax within the meaning of the Sixteenth Amendment. This is because an airline with no book or taxable income and with losses or loss carryovers would nontheless be liable for a tax on excise tax collections, which are of no benefit to the airline/tax collector. This notion turns the basic principle of the income tax on its head. The same logic would produce an income tax on employer withholdings for income and Social Security taxes. By creating an irrebuttable presumption of income at least equal to the amount of the excise tax, the proposal might also violate the due process clause of the Fifth Amendment, in the opinion of our counsel.

Most disturbing to the airlines, the proposal violates the commitment made by Congress and the Executive to ask for extensions of or increases in the user fee scheme only if additional revenue were needed to pay for improving the national air transportation system. Currently, there is a surplus in the Trust Fund of over $4 billion. Raising taxes while the current surplus is not being spent makes no sense at all. And any increase, where needed, should flow to the Trust Fund, not to general revenue as proposed by the Committee.

As Chairman Packwood said during reauthorization of the Trust Fund in 1982, "(i)t is incompatible with the user fee philosophy to continue raising aviation user taxes if the revenues are not being spent for the airport development."

In summary, for the many reasons set forth in this statement, the U.S. scheduled airlines oppose the Finance Committee excise tax proposal and urge that it be rejected as an element of either tax reform or federal budget deficit reduction.

Senator Long. No questions, Mr. Chairman.

The Chairman. Senator Pryor.

Senator Pryor. I don't believe so. Thank you, Mr. Chairman.

The Chairman. Senator Matsunaga.

Senator Matsunaga. Thank you, Mr. Chairman. I wish to join the chairman in congratulating you upon your retirement after 14 years. Is that right?

Mr. Ignatius. About that. A little over that actually.

Senator Matsunaga. And prior to that, I understand, you served as Assistant Secretary of Defense and Secretary of the Navy. At your young age, what are you going to do next?

Mr. Ignatius. I don't have any plans right now, but looks are deceiving. [Laughter.]

Senator Matsunaga. Well, if this be your swan song, I congratulate you.

Mr. Ignatius. Thank you very much, Senator.

Senator Matsunaga. Mr. Dickemper, I want to congratulate you, too, on your very brief but very comprehensive statement. I think you covered in very few words the points that needed to be made and most effectively. And I congratulate you both.

Mr. Dickemper. Thank you, Senator.

The Chairman. Senator Chafee.

Senator Chafee. Thank you, Mr. Chairman. I want to join in congratulating Mr. Ignatius, who has had a very distinguished career. I succeeded him as Secretary of the Navy; and when I took over, everything was in perfect shape.

The Chairman. How was it when you left? [Laughter.]

Senator Chafee. I had a challenge to leave it to my successor in as good shape as I received it.

Senator Pryor. Is there any way we could get both of you to qo back? [Laughter.]

Senator Chafee. But I want to say that Paul Ignatius has been head of the American Air Transport Association [ATA], during a tumultuous period, as we all know.

And he has guided the airlines, I think, in an extraordinarily able fashion. And I must say, as he leaves, he doesn't leave all problems behind him, but the airlines are fortunate that he has been there and done the job so well. So, I want to wish you well.

Amongst other achievements, Mr. Ignatius is a class tennis player, but I don't think he will be turning pro on that. Thank you. I am glad you are here.

Mr. Ignatius. Thank you very much, Senator Chafee.

The Chairman. Senator Long.

Senator Long. Mr. Ignatius, it just occurred to me, based on your very thoughtful statement, that if we put this tax in here and we make people pay an income tax even though they didn't make a profit, at least that ought to satisfy all those people who raised the devil saying certain people paid no taxes. They can say: "Look at this; they lost money and they still paid a lot of taxes." [Laughter.] Maybe they would be satisfied.

The Chairman. Is that it, Russell?

Senator Long. That is all.

The Chairman. Fellows, thank you very much.

Now, if we might have Mr. Peter Handal, Mr. Donohue, Mr. Robert McElwaine, and Mr. John Meagher.

Why don't you go ahead, Mr. Handal?

STATEMENT OF PETER V. HANDAL, PRESIDENT, VICTOR B. HANDAL & BROS., INC., NEW YORK, NY, AND CHAIRMAN, AMERICAN ASSOCIATION OF EXPORTERS AND IMPORTERS

Mr. HANDAL. Thank you, Mr. Chairman. I have a feeling that is a hard act to follow. Mr. Chairman and members of the committee, I am Peter Handal, chairman of the American Association of Exporters and Importers and president of my own company, Victor B. Handal & Bros.

AAEI represents 1,000 companies involved in every aspect of international trade. I am accompanied by Harold Paul Luks, AAEI's representative here in Washington. Our association is opposed to the provision in the chairman's tax proposal to repeal the income tax deductions for the payment of tariffs. Incidentally, this morning each member of this committee received a letter from AAEI and 16 other national trade associations opposing this provision. If anyone would need an extra copy or an additional copy of that letter, we have some here.

As chairman of AAEI, by necessity I must wear two hats, and I must constantly reconcile the needs of exporters and importers. It is not an easy job; however, today my job is made simple by the proposal before you because it is both bad tax reform and bad trade policy. The proposal will harm both American exporters and American importers.

Apparently, this proposal is based on the mistaken assumption that the increased costs resulting from nondeductibility will not be passed on to American consumers. It is inconceivable to us that the increased cost of tariffs would not result in increased prices charged to the American consumers. Moreover, any entities subject to tariffs would have taxable income at least equal to the amount of such tariffs paid, even if the company were operating at a net loss.

In addition, such income would be subject to tax at the top corporate rates against which no credits could be claimed. If you turn to page 4 of my prepared statement, you will note the devastating effects of the proposal, which can turn a modest, after-tax profit into a significant cash loss. The only alternative is to raise prices, and this illustrates the regressive character of the proposal.

I hope to have an opportunity later, if you are interested, to work through a specific examole. AAEI feels that the proposal is both bad tax reform and bad trade policy. Let us first discuss the tax policy consequences of the proposal. First, the proposal would impose a new regressive tax burden on those least able to afford a tax increase. It increases the cost of goods, often basic necessities, to low and middle income families, thereby withdrawing in part the proposed reduction in personal income tax rates.

Second, the proposal would result in increased tax liabilities for many corporations, thus arbitrarily reducing the benefits of the proposed reduction in the corporate income tax. Third, the proposal would result in major economic distortions which have been neither anticipated nor even studied by the Congress or the administration.

We are frankly surprised that this committee with its history of thoughtful analysis of economic problems would consider for a moment the repeal of deductibility of tariffs without regard to its impact on the U.S. economy, on the U.S. competitiveness, productivity, standard of living, budget deficits, and trade deficits as well.

Next, the repeal of tariff deductibility is bad trade policy for four reasons. First, the proposal would diminish the competitiveness of U.S. exports by increasing the cost of U.S. products which incorporate imported parts. Second, an effective unilateral increase in tariffs by the United States probably will trigger retaliation against U.S. exports. Third, it appears to be inconsistent with our international agreements, specifically GATT articles II and III, and we feel it may be cause for an article 23 action against the United States.

Fourth, the proposal will seriously impede the U.S. efforts to initiate a new round of multilateral trade negotiations designed to reduce barriers to U.S. exports of goods and services. Mr. Chairman and members of the committee, AAEI supports fully the objectives of negotiating new international agreements to expand trade in high technology products and services, to enhance multilateral protection for intellectual property, and to lower barriers to foreign investment; but how can the United States pursue these objectives if our own tax laws raise tariff barriers and violate international trade agreements?

In conclusion, the tariff increases through domestic tax policy contravenes any equitable notion of tax reform and is inconsistent with the national trade policy. AAEI strongly recommends that you eliminate the tariff proposal from the pending tax package.

Thank you.

The CHAIRMAN. Thank you. Mr. Donohue.

[The prepared written statement of Mr. Handal follows:]

TESTIMONY OF

PETER V. HANDAL
CHAIRMAN

THE AMERICAN ASSOCIATION OF
EXPORTERS AND IMPORTERS

BEFORE THE
SENATE COMMITTEE ON FINANCE

REGARDING

THE PROPOSAL TO ELIMINATE THE
DEDUCTIBILITY OF
TARIFF PAYMENTS

APRIL 21, 1986

Mr. Chairman, members of the Committee. I am Peter V. Handal, Chairman of the American Association of Exporters and Importers ("AAEI) and President of Victor B. Handal & Bro. AAEI represents over 1,000 companies involved in every aspect of international trade. I am accompanied by Harold Paul Luks, AAEI's Washington Representative. Thank you for the opportunity to share with you today our very serious concerns about the pending tax legislation.

We view with considerable apprehension the provisions in the Chairman's tax proposal to repeal the long-standing income tax deduction for the payment of tariffs. Today, other witnesses will describe the negative economic effects associated with the repeal of the deduction of excise taxes. As an organization primarily interested in international trade, our remarks will focus on the proposal to repeal the existing deduction for tariff payments.

We are not alone in our opposition to these provisions. In addition to its more than 1,000 member firms, AAEI has joined with 15 national associations, representing a major segment of the U.S. economy involved in world commerce, in expressing opposition to the repeal of tariff deductibility. On April 17, 1986, this ad hoc coalition of national associations sent a letter to the Senate and key Administration officials specifying its objections to the repeal of the tax deduction for tariffs.

The proposal to eliminate tariff deductibility reflects an unfortunate tendency to view tax policy without regard for its potential adverse consequences on trade policy, or to view trade policy in isolation from its potentially damaging effects on U.S. foreign policy. Viewed solely as a matter of tax policy, the repeal of tariff deductibility is bad policy. And, viewed solely as a matter of trade policy, the proposal will damage the international economic interests of the United States.

As Chairman of the American Association of Exporters and Importers I wear two hats. I must constantly reconcile the needs of our member firms which export with the needs of our member firms which import. The tariff proposal will adversely affect both U.S. exporters and U.S. importers. AAEI, therefore, urges this Committee to recognize that the provision to eliminate the tax deductibility of tariffs is neither sound tax reform nor sound economic and trade policy.

AAEI's principal concerns are the negative economic consequences which would result from the repeal of the existing deduction. This proposal is apparently based on the mistaken assumption that the increased cost resulting from non-deductibility will not be passed on to consumers. It is inconceivable that increased liability for the payment of tariffs on dutiable imports would not result in increased prices charged to U.S. consumers.

The Chairman's proposal would not only repeal the currently available deduction, but would go so far as to ensure that, irrespective of net income, any entity subject to tariffs would have taxable income at least equal to the amount of such taxes and tariffs paid -- even if the company were operating at a net loss. Moreover, such income would be subject to tax at top corporate rates against which no credits could be claimed.

Tax Analysis of Proposal's Impact

Current		Proposal	Price Increase to Yield Current Profit Level
Cost to Importer	6.00	6.00	
Tariff (20%)	1.20	1.20	
Ocean Freight	.40	.40	
Other Import Costs	.40	.40	
Landed Cost	8.00	8.00	
Wholesale Price to Retailer	9.50	9.50	$9.50 +.62 = 10.12
Less Landed Cost	(8.00)	(8.00)	(8.00)
Gross Profit	1.50	1.50	2.12
Overhead and Other Expenses	1.30	1.30	-1.30
Pre-Tax Profit	.20	.20	.82
Federal Income Tax	.09[1]	.49[2]	$ .71[3]
After Tax Profit	.11	Loss (.29)	$ .11

This example illustrates why prices will react to the proposal and further illustrates the inequities of the proposal.

Viewed from another perspective, the proposal represents a substantial increase in tariff rates by an amount substantially equivalent of this inevitable income tax liability -- costs which will be borne by individual U.S. consumers and by U.S. industries which incorporate imported components into end-use products. In other words, a U.S. business must either absorb increased costs resulting from higher effective tariffs, and place its economic security in jeopardy, or pass its increased costs to U.S. consumers. There is no economic theory, postulate, or model which can deny the inevitability of such consequences.

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[1] Assume 46% rate; 46% of .20.

[2] Assume 35% rate and nondeductibility of tariff; 35% of 1.40.

[3] Assume 35% rate and nondeductibility of tariffs; 35% of 2.02.

AAEI believes the following points present sufficient cause for the Committee to reject the proposal to repeal tariff deductibility. My remarks are divided into two sections: first, the Chairman's proposal is unsound tax policy, and, second, the proposal is unwise trade policy.

I. THE REPEAL OF TARIFF DEDUCTIBILITY IS BAD TAX POLICY AND WHOLLY INCONSISTENT WITH TAX REFORM

A. The Proposal Would Impose a New Regressive Tax Burden on Those Least Able to Afford a Tax Increase

A general rise in costs for dutiable imports, and products which contain imported components, will plainly be accompanied by a rise in prices for these products. Many affected products are necessities for which low-income Americans spend a disproportionately large share of income. For example, individuals in the bottom fifth of the income scale spend 10.5 percent of income for clothing. The national average is only 4.5 percent. In fact, many imported goods are consumed directly or indirectly by lower and middle income Americans. The regressive character of the tariff proposal becomes most apparent when one realizes that it would fall most heavily on such basic necessities as clothing, where some tariff rates approach 40 percent. Repealing the deduction for tariffs will also increase the domestic price level -- thereby contributing to inflation and reducing the real income of all consumers.

In essence, those very same Americans to whom a tax cut is promised, will be paying for their own tax cuts through increased prices and will feel little or no net benefit.

B. The Proposal Would Result in Increased Tax Liabilities for Many Corporations, Thus Reducing the Benefits of the Proposed Reduction in the Corporate Income Tax

Coupled with non-deductibility of excise taxes, the tariff proposal would increase the tax liability for many corporations -- thereby eliminating the proposed benefits of any reduction in corporate tax rates. In effect, the bill would redistribute tax burdens within the U.S. economy by discriminating against those who are liable for tariffs and excise taxes.

Moreover, this proposal is offered without regard to its impact on the U.S. economy generally, U.S. competitiveness, productivity, standard of living, or budget deficits. The proposal is made hastily and arbitrarily. It will result in random, unplanned, and unforeseen economic distortions by imposing increased costs on imported products without any justification or rationale. AAEI is puzzled that, in light of this Committee's mandate to consider legislation to enhance the competitiveness of American products in our marketplace and in world markets, the tariff proposal is being considered without regard to the objectives.

C. The Proposal Would Result in Major Economic Distortions Which Have Been Neither Anticipated Nor Even Studied by the Congress or the Administration

Available private sector studies of the proposal confirm its tax regressivity and distorting effects on trade. Elimination of the tax deduction for tariffs is expected to raise $15 billion over the next five years. Proponents of the Chairman's proposal claim this provision must be part of tax reform in order to keep the total tax bill revenue neutral.

To date, however, neither the Joint Committee on Taxation, the General Accounting Office, the

Congressional Budget Office, Treasury Department, nor the Office of Management and Budget has released any report or study which even considers the effects of the proposal. The approach to tax reform should neither be "Lower rates at any cost," nor "Damn trade policy, full speed ahead."

AAEI is convinced that serious study will show that the tariff and excise tax proposals are irreparably flawed. The proposals are nothing more than regressive tax increases which are plainly misplaced in any tax reform bill. Moreover, this unsound tax policy would immediately be recognized abroad as a thinly veiled tariff hike and would trigger trade retaliation by foreign countries against our most competitive exports in the form of higher tariffs.

II. THE REPEAL OF TARIFF DEDUCTIBILITY IS BAD TRADE POLICY

A. The Proposal Would Diminish the Competitiveness of U.S. Exports

Repeal of tariff deductibility will increase the costs to U.S. companies producing products containing imported raw materials, parts, and components. Accordingly, the proposal will drive up the price of U.S. products in foreign markets (as well as U.S.

markets), despite the decline in the value of the dollar, and thereby reduce U.S. competitiveness.

It is undetermined in the Chairman's bill whether U.S. exporters will be able to obtain a refund (duty-drawback) for tariff payments. Under current law, customs duties assessed on imported goods are refunded when such goods are subsequently reexported or exported when manufactured into a different article of commerce. Because the payment of tariffs automatically results in a tax liability, the bill leaves unclear the mechanics of determining the extent to which U.S. exporters will benefit from duty-drawback.

B. The Proposal Would Result in Violations of International Obligations and, Thereby, Cause Retaliation against U.S. Exporters and U.S. efforts to Secure the Elimination of Barriers to U.S. Exports

An effective unilateral increase in tariffs by the United States: (A) may trigger retaliation against U.S. exports, (B) appears to violate GATT Articles II (Schedules of Concessions) and III (National Treatment of Taxation), and (C) will impede seriously U.S. efforts to initiate a new round of multilateral trade negotiations.

1. The Proposal Invites Foreign Retaliation

The Chairman's provision would result in an effective tariff increases of up to 54%, assuming a proposed top corporate tax rate of 35%. Top tariff rates now approach 40%. Imposing a 35% income tax on this expense effects a grossed-up liability of some 54%. An effective increase in U.S. tariffs would allow the GATT contracting parties to claim a nullification and impairment of GATT-negotiated trade concessions under Article XXIII of the GATT.

If the Chairman's proposal were to become the law of the land, it would result in a long and united queue of trade ministers at the GATT petitioning for authorization to retaliate against the United States. Even assuming that the United States was able to prevent the GATT Council from officially authorizing retaliation, the international trading community would, nevertheless, likely raise tariffs or take other adverse measures against U.S. exports. In such circumstances, the United States would thus contribute to the breakdown of the GATT system at precisely the moment we are about to seek a substantial strengthening of the GATT's mechanisms and procedures to resolve trade disputes.

A basic concept of the GATT system is the "binding" of customs duties on particular items in the tariff schedules of the individual Contracting Parties. Binding means that tariffs may not be effectively increased above the rates specified in a trade agreement. It is the view of AAEI that, if a GATT contracting party increases its effective tariff rates to a higher level than its "bound" rates, then those countries which would otherwise benefit from the binding have a right under GATT to retaliate against the offending country's exports or to receive compensation. Furthermore, AAEI maintains that a binding of tariffs would be meaningless if other forms of taxation on imports could be varied at will.

An effective increase in tariffs directly contravenes the tariff reductions agreed to in the 1979 Tokyo Round of Multilateral Trade Negotiations ("MTN") which "bound" the Tariff Schedules of the United States. The proposal to repeal tariff deductibility would, without question, unravel the MTN tariff agreement, forestall the last staged MTN tariff reduction scheduled to take effect on January 1, 1987, and thwart the U.S. objective of lowering tariff barriers to international commerce.

2. The Proposal Appears to Violate Articles II and III of the GATT

An effective increase in tariffs violates Article II of the GATT which states that products which are bound to certain tariff rates shall not be subject to any excess duties or charges "imposed on or in connection with importation." [Art. II 1(b)(C)].

An effective increase in tariffs also violates Article III of the GATT. Proponents of repealing tariff deductibility assert that it is entirely consistent with the GATT since deductibility would be disallowed for tariffs and excise taxes, whether imposed on domestic products or imports. However, merely placing the same sort of burden on certain limited classes of domestic products and all imported products and, at varying effective rates depending upon the level of excise tax and duty, does not make the proposal consistent with the GATT. Article III(2) of the GATT provides:

> "The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes on other internal charges to imported or

> domestic products in a manner contrary to the principles set forth in paragraph 1." [Emphasis added.]

Paragraph 1 of Article III states:

> "The contracting parties recognize that internal taxes and other internal charges . . . should not be applied to imported or domestic products so as to afford protection to domestic production." [Emphasis added.]

And, Article III, paragraph 4 claims:

> "The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale offering for sale, purchase, transportation, distribution or use."

For example, the proposal before the Committee provides greater protection from imports to the domestic textile, apparel, steel, and footwear industries. As John Jackson, a noted authority on the GATT, has written: "A tax that merely provided for equal treatment for like products, while cleverly imposing a heavier burden on those particular products that are mostly imported, would not seem consistent with the GATT national treatment obligation." Article III(2) is not concerned with the intent of the extra charge on imports. The pertinent words are "should not be applied . . . so as to afford protection to domestic production." The effect of the internal charge or tax, in this case the proposed repeal of deductibility, is what concerns the GATT contracting parties.

3. The Proposal Will Undermine U.S. Efforts to Institute a New Round of Multilateral Trade Negotiations

Perhaps the most important consequence of the Chairman's proposal is the chilling effect it will have on U.S. efforts to initiate a new round of multilateral negotiations. The United States can hardly expect to achieve a multilateral consensus on methods to break down non-tariff barriers to exports when Congress unilaterally imposes impediments to fair trade at the expense of all U.S. taxpayers.

* * *

Mr. Chairman and members of the Committee, AAEI supports fully the objectives of negotiating new international agreements to facilitate trade in products based on advanced technology, to enhance multilateral protection for intellectual property, and, to lower barriers to foreign investment and to improve trade agreements through multilateral negotiations. How then can the United States pursue these objectives if our tax laws raise tariff barriers and violate international trade agreements.

In conclusion, manipulating tariff increases through domestic tax policy contravenes any equitable notion of tax reform as well as our fundamental international trade policy. Eliminating the existing deduction for tariffs would impose a new tax burden on lower and moderate income families. The proposal will negate, in part, reductions in personal and corporate income taxes contained elsewhere in the Chairman's tax bill. As a matter of trade policy, the proposal may lead to retaliation against U.S. exports, violates international agreements, and is irreconcilable with the objective of developing new international trade agreements.

AAEI strongly recommends that you eliminate the tariff proposal from the pending tax package.

STATEMENT OF PHILIP KNIGHT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NIKE, INC., BEAVERTON, OR, PRESENTED BY MR. DONOHUE

Mr. DONOHUE. Mr. Chairman, thank you very much. As you know, I am a late substitute for Philip Knight, president of Nike; and as you know, Nike is Oregon's third major employer and one of the largest producers, importers and sellers of athletic shoes and apparel in this country.

This year we will have sales in excess of $1 billion. In addition to that, Nike's domestic export operations impact on the employment of thousands of individuals throughout the United States. We realize the tremendous amount of work that has gone into this bill. However, we are appearing before the committee today because we feel that the proposal is fatally flawed. We strongly oppose the provision in the proposal which denies the deductibility of tariffs.

Nike takes issue with your comments, Mr. Chairman, as they appeared in the March 29, 1986 "Oregonian." In that article, you are quoted as saying: "From Oregon's standpoint, I don't see how we can come out losers." Under this tax reform proposal, as the third largest employer in the State, Mr. Chairman, I can assure you that Nike comes out a loser.

If the proposal to eliminate the deductibility of tariffs had been the law during Nike's last fiscal year, even assuming that the maximum corporate rate is lowered to 35 percent, instead of showing a $10 million profit as we did Nike would have an $8.5 million loss. The proposed nondeductibility of tariffs would have cost Nike $18 million in fiscal year 1985. If the deductibility of tariffs is eliminated by the passage of this tax bill, the unfortunate reality is that Nike will have no alternative but to attempt to pass our increased costs on to the American consumer.

Even if this shift is possible, it will not necessarily solve our problems. American consumers are intelligent and discriminating. They have a built-in sense of what a product is worth, and they know what they are willing to pay for it. Market surveys indicate that there is a price level for every product beyond which a consumer will not go.

An exact determination as to what the price level may be for any given product often is impossible to know before it is too late. If this tariff provision is enacted, in order to maintain the level of profitability which we are now experiencing, Nike would be required to increase its wholesale price to its dealers by approximately $35 million per year. Resulting increased costs to American consumers would amount to approximately $70 million.

The unfortunate end result of increased prices by this amount is that the brunt of the increase will be borne by persons in the lower- or middle-income brackets who are least able to afford it. The average retail prices for apparel items sold by Nike during the first 9 months of this year was only $15.68. When one realizes that some of the apparel items in our line retail for in excess of $100, it is easy to see that an inordinate amount of inexpensive items are being sold in order to arrive at such a low-average price.

The same trend is reflected in sales of Nike's footwear where the average-retail price of shoes sold is $33.18. As a specific example, in

Oregon sales of apparel items at a price less than $15.68 totaled 700,000 units for the first 9 months of this fiscal year. Shoe sales at prices less than the average price have totaled approximately 1.2 million pairs. These Oregon sales figures primarily represent sales to lower income individuals and are families with children and are representative of sales in States throughout the United States.

It is obvious that this forced change of consumer buying habits will have a potentially devastating impact on the total sales of Nike, Inc. The impact will not only seriously erode the investment made by stockholders in our company, but also will undoubtedly be translated into loss of jobs, not only by Nike's own employees, but by those thousands of other workers throughout this country who derive their employment, at least partially, through their involvement with transportation or sales of Nike brand products.

Under the proposal as written, both Nike and the trucking industry would suffer. Truckers would pass their increased excise tax liability to Nike in the form of higher freight costs. Higher freight costs will increase further the cost of our products. Faced with a more expensive Nike product, more consumers will switch to less expensive products; and Nike will suffer an irreparable loss.

Nike is a major importer in this country. Nike's tariff payments, which sometimes run as high as 35 percent of the value of the product, amounted to $55 million last year. During the fiscal year this year, Nike will increase to in excess of $57 million. Nike's tariff payments exceed the total profits realized by our company during these 2-year periods. These tariffs go directly to the Federal Government and are above and beyond any other taxes that Nike pays.

The solution to this situation, we submit, is not to increase the tax burdens for a handful of corporations by denying deductibility of tariffs and excise taxes, but rather to focus on the loopholes in the current code and to close those loopholes so that all segments of corporate America will shoulder their fair share of the income tax burden. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. McElwaine.

[The prepared written statement of Mr. Knight follows:]

TESTIMONY OF PHILIP H. KNIGHT
PRESIDENT AND CHIEF EXECUTIVE OFFICER
OF NIKE, INC.
BEFORE THE SENATE FINANCE COMMITTEE
APRIL 21, 1986

Mr. Chairman and Members of the Senate Finance Committee, thank you for this opportunity to appear before you today to testify on behalf of NIKE, Inc. We are particularly pleased to be appearing today before our distinguished Senator from Oregon, the Chairman of this Committee.

Mr. Chairman, as you know, NIKE, Inc. is one of the largest producers, importers and sellers of athletic shoes and apparel in this country. In this fiscal year we will have sales in excess of one billion dollars. Headquartered in Beaverton, Oregon, NIKE, Inc. currently employs more than 1,500 people in Oregon, making us the third largest non-governmental employer in that State. In addition to that, NIKE's domestic and export operations impact on the employment of thousands of individuals throughout the United States.

We realize the tremendous amount of work that has gone into this draft tax reform proposal and we commend the Chairman and Committee staff for their efforts; however, we are appearing before this Committee today because we believe that the proposal is fatally flawed. We strongly oppose the provision in the proposal which denies the deductibility of tariffs.

NIKE, Inc. takes issue with your comments, Mr. Chairman, as they appeared in the March 29, 1986 "Oregonian." In that article you were quoted as saying, "From Oregon's standpoint I don't see how we can come out losers ... " under this tax reform proposal. As the third largest employer in the State, Mr. Chairman, I can assure you that under the version of tax reform pending before this Committee NIKE, Inc. comes out a loser. If the proposal to eliminate the deductibility of tariffs had been the law during NIKE's last fiscal year, even assuming that the maximum corporate rate is lowered to 35%, instead of showing a 10 million dollar profit, as we did, NIKE, Inc. would have had an 8.5 million dollar loss. Mr. Chairman the proposed nondeductibility of tariffs would have cost NIKE 18 million dollars in fiscal year 1985.

Because NIKE, Inc. is a publicly held corporation we are responsible to our shareholders. We cannot stand idly by and allow this misguided provision to destroy our profitability and perhaps our company. If the deductibility of tariffs is eliminated by the passage of this tax bill, the unfortunate reality is that NIKE, Inc. will have no alternative but to attempt to pass our increased costs on to the American consumer.

Even if this shift in costs is possible, it will not necessarily solve NIKE's problem. American consumers are intelligent and discriminating. They have a built-in sense of what a product is worth and they know what they are willing to pay for it. Market surveys indicate that there is a price level for every product beyond which a consumer will not go. An exact determination as to what that price level may be for any given product often is impossible to know until it is too late. Thus price increases necessary to salvage the impact of this tariff provision will in all likelihood exceed this built-in maximum consumer price, and will result in diminished sales of NIKE brand products.

If this tariff provision is enacted, in order to maintain the level of profitability which we are now experiencing, NIKE, Inc. would be required to increase its wholesale price to its dealers in the amount of $35 million per year. The resulting increased cost to American consumers would amount to approximately 70 million dollars. The unfortunate end result of increasing prices by this amount is that the brunt of the increase will be borne by persons in the middle or lower income brackets who are least able to afford it.

To illustrate this effect, the average retail price for all apparel items sold by NIKE, Inc. during the first nine months of this fiscal year was only $15.68. When one realizes that some apparel items in our line retail for in excess of $100.00, it is easy to see that an inordinate number of inexpensive items are being sold in order to arrive at such a low average price. The same trend is reflected in sales of NIKE footwear where the average retail price of all shoes sold is $33.18. Again the vast majority of these sales are to consumers who purchase shoes at prices lower than this. As a specific example, in Oregon, sales of apparel items at a price less than the $15.68 average retail price have totaled 700,000 units for the first nine months of this fiscal year. Shoe sales at prices less than the average price have totaled approximately 1.2 million pairs. These Oregon sales figures primarily represent sales to lower income individuals and/or families with children, and are representative of sales in states throughout the Nation.

As prices are increased to offset losses due to this tariff proposal, these average sales figures will also increase. At some unknown point consumers will no longer be able to afford or will simply refuse to buy NIKE products. They must then turn to a lower priced product from one of our competitors in order to provide shoes and clothing for themselves and their children.

NIKE, Inc. is not the only company who will suffer as a result of the passage of this measure. Our competitors will meet with a similar fate, necessitating a resulting increase in the price of their products. The American consumer then will be forced either to purchase NIKE products at an increased price or to purchase an inferior quality product at a newly inflated retail price.

It is obvious that this forced change in consumer buying habits will have a potentially devastating impact on the total sales of NIKE, Inc. This impact will not only seriously erode the investment made by American stockholders in our company but also will undoubtedly be translated into a loss of jobs not only by NIKE's own employees but by those thousands of other workers throughout this country who derive their employment at least partially through their involvement with the transportation or sale of NIKE brand products.

The economic dislocation in the transportation industry brought about by decreased transportation needs of shippers such as NIKE, Inc. will be severely compounded by the other aspect of the provision which is the subject of today's hearings -- i.e., the denial of deductibility of excise taxes. Because NIKE, Inc. and the trucking industry are so closely tied together, any impact on one of them causes an immediate impact on the other. At the present time all NIKE products sold in this country, whether manufactured by domestic companies or imported from overseas, are at some point within the distribution chain, handled and transported by the American trucking industry. Whether the products move across the country in a semi or down the block in a delivery van, they must be transported by truck. Each year NIKE, Inc. pays several million dollars in freight charges to the trucking industry to move our products around the country.

Under the proposal as written, both NIKE, Inc. and the trucking industry will suffer. Because of reduced sales resulting from the nondeductibility of tariffs, NIKE, Inc. will be forced to reduce the distribution of its products and its corresponding need for transportation. This curtailment will obviously have a direct and negative financial impact on the trucking industry. At the same time the elimination of the deductibility of excise taxes will force the trucking industry to take the same action forced upon NIKE, Inc., i.e., they will increase their freight rates.

Thus, truckers will pass their increased excise tax liability to NIKE, Inc. in the form of higher freight costs; higher freight costs will increase further the cost of our products; faced with a more expensive NIKE product, more consumers will switch to less expensive products; and the resulting decline in NIKE products sold will mean fewer products transported in trucks. This double whammy effect resulting from passage of the excise tax and tariffs provision creates an inflationary spiral which like an unleashed tornado will siphon additional revenue from the pockets of the American consumer.

NIKE, Inc. is and has been a strong supporter of the original goals of the tax reform effort -- a simpler and fairer tax code in which everyone pays his fair share of taxes and which promotes and enhances the economic growth of this Nation. This proposal would not enhance these goals; it would defeat them.

As one of the major importers in this country, NIKE, Inc. already pays substantial amounts of money directly into the U.S. Treasury in the form of tariffs on imported goods. NIKE, Inc.'s tariff payments, which sometimes run as high as 35% of the value of the product, amounted to $55 million dollars last year. During this fiscal year the amount paid by NIKE, Inc. will increase to in excess of $57 million. Incredible as it may seem, NIKE, Inc.'s tariff payments exceed the total profits realized by our company during this two year period. These tariffs go directly to the federal government and are above and beyond any other taxes NIKE, Inc. pays. If the proposal is adopted denying a deduction for these tariffs, we will be forced to pay tax on these duties even though we never recognize any increase in our income from them.

Passage of this provision would unfairly put the burden of revenue raising on corporations such as NIKE, which have always contributed their fair share to the support of this country. As a matter of fact, from the time NIKE, Inc. became a publicly owned corporation in 1981 through the projected fourth quarter of fiscal year 1986, we will have paid a total of $202 million in federal income taxes and an additional $36 million in various state taxes. Throughout that same 5 year period the total profits realized by our company amount to $195 million or some $43 million less than taxes paid.

Mr. Chairman, in the Northwest alone there are at least three large corporations which last year paid absolutely no federal income taxes whatsoever. They apparently accomplished this through use of the loopholes in the current code. To a company like NIKE, Inc. who believes in doing our part in supporting this country, this is offensive.

The solution to this situation, we submit, is not to increase the tax burdens of a handful of corporations by denying deductibility of tariffs and excise taxes, but rather to focus on the loopholes in the current code and to close those loopholes so that all segments of corporate America will shoulder their fair share of the income tax burden.

The tariffs and excise tax proposal is a backdoor method of raising revenue simply by increasing prices to the average taxpayer. This is regressive taxation, plain and simple.

No, Mr. Chairman, this proposal is not good for Oregon, it's not good for NIKE, Inc., it's not good for the Oregon trucking industry and it's not good for Oregon consumers.

Mr. Chairman and Members of this Committee we strongly urge you to focus on the true and stated purpose of this tax reform effort and to reject the proposal before the Committee today.

Thank you very much for your attention and consideration in this matter.

STATEMENT OF ROBERT M. McELWAINE, PRESIDENT, AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION, WASHINGTON, DC

Mr. McELWAINE. Mr. Chairman, distinguished members of this committee, thank you for sticking with us through this long day to hear our views on this vital issue. I am accompanied by Dr. Bart Fisher of Patton, Boggs & Blow. Dr. Fisher and his colleagues have prepared an extensive economic study which has been submitted for the record.

I would like to merely touch on the three main points of that statement, one being that the proposed disallowance of the deductibility of tariff payments would in essence be a reversal of our historic tax policy in that it would tax what is a very essential cost of doing business for the first time in our history. Second, that the proposal runs counter to U.S. trade objectives today in that it would create what would be an effective increase in our tariff rates of about 54 percent.

I don't think that I have to remind the committee that this is a much higher increase in existing tariffs than we put into effect in 1930 with the Smoot-Hawley tariff law, with all the resulting social and economic horrors that that particular action brought about. Finally, the paper deals with the economic effect—the adverse economic effects—that this proposal would have on the United States; and I would like to spend the minutes I have here discussing that one issue.

The result of this particular proposal on our industry would be an increase in the payments that we make for tariffs of 54 percent. Now, last year the imported automobile industry paid tariffs of $2 billion to the U.S. Treasury. This accounted for one out of every $6 that were paid into the Treasury in tariff payments. The result of this particular measure would be to increase that cost by approximately $1 billion.

This would have to be passed on to the consumer since the recent fall of the dollar against the yen, the mark, and other foreign currencies has virtually eliminated the profit margins for the companies importing automobiles into this country today; and they would have no choice but to pass this on. So, we have a $1 billion increase in the cost of imported automobiles to the consumer.

And if that were the end of it, that would be bad enough; but that is really only the beginning. The experience of the past 10 years has shown us that, every time imported automobiles have a price increase, the domestic automobile makers increase their prices almost in a mirror image. We saw this first in 1977–78 when the falling dollar caused five increases in the cost of Japanese automobiles in 1 year, and those five price increases were immediately mirrored by the domestic manufacturers, although they had no comparable increases in their own costs.

During the latter part of the 1970's, we imposed a 25-percent duty on the importation of trucks into this country. Domestic manufacturers immediately increased the prices of their trucks by the same $1,000 that this tariff increase put on the imported product. During the years of the voluntary restraint agreement on Japanese cars, the resulting shortages of Japanese cars raised the prices of those cars by about $2,500 a car. At the same time, according to the Brookings Institute, the domestic manufacturers raised their prices right along with the imported cars as well.

This resulted in net profits for the big three in Detroit of $25 billion in the past 3 years, which far exceeds their profit level for any decade in the history of the industry. So, what we would see would not be just a $1 billion increase in the cost of imported automobiles, but a $2 billion increase in the cost of domestic cars as well.

We would, in effect, be putting a hidden tax on the consumer of $3 billion in order to realize for the Treasury approximately $900 million in revenue. Surely, Mr. Chairman, there must be a more efficient way to raise revenue than by this one-for-three method that this system would impose.

Thank you.

The **Chairman**. Thank you. Mr. Meagher.

[The prepared written statement of Mr. McElwaine follows:]

STATEMENT OF THE AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION BEFORE THE COMMITTEE ON FINANCE

The American International Automobile Dealers Association (AIADA) represents the interests of over 7,000 American automobile dealers and their approximately 170,000 employees. We appreciate the opportunity to participate in this hearing on the Chairman's tax reform proposal concerning the deductibility of tariffs and excise taxes. AIADA has a particularly strong interest in the issue of tariff deductibility. Last year, the imported automobile industry paid approximately $2.0 billion in tariffs, all of which was fully deductible as a business expense.1/ One out of every six dollars paid in tariffs in 1985 was paid by the imported automobile industry. Should the

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1/ The $2.0 billion in tariffs paid by the imported automobile industry in 1985 breaks down as follows:

Product	Tariff Rate	Amount Collected in Revenues
Automobiles	2.6%	$ 697 million
Light trucks	25%	$ 900 million
Medium and heavy-duty trucks	4%	$ 15 million
Parts for automobiles and light trucks	Various rates	$ 400 million
		$2.012 billion

Source: U.S. Department of Commerce, Pub. IM 146 (December 1985).

Chairman's proposal be adopted, real tariff costs would increase by approximately $920 million for the imported automobile industry.

We urge the Committee to reject the tariff nondeductibility proposal for four reasons.

1. Tax Policy

First, it is an unjustified and discriminatory departure from longstanding U.S. tax policy. In no case other than tariffs and excise taxes does the Chairman propose to eliminate the deductibility of ordinary and necessary business expenses.

2. Consumer Costs

Second, the proposal would result in huge increases in the cost of consumer goods. For example, it is certain that the vastly expanded tax liability incurred by the imported automobile industry would result in significantly higher prices for automobiles, both imported and domestic, permitting monopoly profits of over $1 billion to be reaped by the big three automobile manufacturers at the expense of the American consumer.

3. Constitutional Questions

Third, because of the proposal's unusual "anti-avoidance" provisions, it would almost certainly be subject to a constitutional challenge.

4. Trade Policy

Fourth, the proposal runs counter to U.S. international trade objectives: The imposition of a substantial increase in "effective" tariff rates raises serious questions under the

General Agreement on Tariffs and Trade (GATT) and is likely to lead to retaliation by our trading partners. The views expressed below are consistent with the interests of our membership; however, it is also in the broader domestic and international interests of the United States to reject this proposed revenue enhancement measure.

1. The Chairman's Proposal Reverses Fundamental U.S. Tax Policy

A fundamental principle of the U.S. income tax code is its distinction between gross receipts and net income. In determining the taxable income of taxpayers engaged in business or profit-oriented activities, our federal system of taxation focuses on net profits rather than on gross receipts or gross income. In fashioning the Internal Revenue Code, Congress has consistently expressed its conviction that the deductibility of unavoidable business costs is a matter of *fairness*. The theory is a sound one -- you are taxed on the income you earn, not on the cost of earning income. Thus, tariffs and excise taxes incurred as "an ordinary and necessary expense" of doing business or producing income are deductible from gross income. Treas. Reg. § 1.164-2(f).[2/]

[2/] Tariffs are deductible only when incurred as an ordinary and necessary *business* expense. Accordingly, a taxpayer who incurs tariff or excise tax liability on *consumer* purchases -- for example, the individual who is charged customs duties on expensive personal items brought back from Europe -- cannot take a deduction. This different treatment of business and consumer costs is perfectly consistent with the tax code's general treatment of business versus personal expenses.

There appears to be no support in Congress or elsewhere for the total elimination of deductions for business expenses. Rather, this proposal is a selective measure, the single purpose of which is to raise revenue. But if it is adopted, Congress will establish the dangerous and ill-considered precedent that not all ordinary and necessary business expenses are deductible. By doing so, the logic of the entire tax system is drawn into question.

It is particularly unfair that the Chairman's proposal singles out tariffs and excise taxes for nondeductibility. Both of these costs constitute absolutely necessary expenses of carrying on a trade or business. In the case of tariffs, every U.S. business that imports dutiable goods or components is legally required to pay tariffs at the established rate. Importers who avoid paying appropriate tariffs are subject to criminal penalties under procedures established by the U.S. Customs Service and the Justice Department. Certainly the costs of tariffs and excise taxes are more "necessary" than other common business deductions, such as advertising or entertainment expenses.

Furthermore, tariffs and excise taxes are business costs which are imposed upon a discrete segment of the economy. Especially in the case of tariffs, there is an identifiable group of enterprises -- those which are engaged in importing or those which purchase foreign-made products or components -- that will be hardest hit. Thus, the Chairman's proposal is both a radical departure from conventional tax policy and discriminatory in effect.

A Tax on Fictitious Income

Chairman Packwood's proposed disallowance of tariff and excise tax costs not only represents a departure from the "net income" concept, but also appears to create a tax that is not based on "income" at all. Since these costs are expenditures directly connected with the production or acquisition of goods held for sale, they are universally classified as capital costs. As such, they must be included in the taxpayer's "cost of goods sold" (along with the cost of raw materials and other direct costs) and subtracted from gross receipts to arrive at gross income. Net income is then determined by a further set of calculations and deductions. Thus, a tax on tariff or excise tax costs is not a tax on real "income". It is in fact a tax on a tax, a ludicrous concept.

A final and particularly bizarre feature of the Chairman's proposal is the so-called anti-avoidance provision. This rule stipulates that taxpayers liable for payments of tariffs and/or excise taxes would be deemed to have taxable income in an amount no less than their tariff and excise tax liability. Thus, a taxpayer whose net income is less than his tariff and excise tax liability would pay income taxes on the higher amount. Indeed, it appears that even a firm suffering losses would pay income tax based on tariff and excise taxes paid. The anti-avoidance provision would result in the imposition of tax on fictitious income. As such, it is open to constitutional challenge and, if not rejected by this Congress, could be set aside by the courts.

Constitutional Analysis

Prior to the passage of the Sixteenth Amendment, Congress was limited in its power to impose any form of direct tax on individuals or corporations. This limitation was generally ascribed to the substantive requirement of Article I, Section 9 of the Constitution that any "direct" tax be apportioned among the states.[3] The Sixteenth Amendment, which was ratified by the requisite number of states in 1913, eliminated the requirement that an income tax be "apportioned."[4] According to renowned tax scholar Boris Bittker, a corollary of this principle is that any direct tax not imposed on "income" remains subject to the rule of apportionment.[5]

The Chairman's proposal clearly deviates from the idea of a tax imposed on income, particularly by virtue of the anti-avoidance rule that would tax fictitious income. As discussed above, such income would be calculated without any regard for business earnings or even gross receipts, but rather on the basis of an expense (the taxpayer's excise tax and tariff liability). Moreover, by denying the deduction for a capital cost that should be included in cost of goods sold, the proposed change will result in a tax on capital, as opposed to a tax on income. A tax is "on incomes" within the meaning of the Sixteenth Amendment only if all capital costs are permitted to be subtracted from gross receipts in order to determine gross income. See Doyle v. Mitchell Brothers Co., 247 U.S. 179, 185 (1918); and Helvering v. Independent Life Ins. Co., 292 U.S. 371, 381 (1934). Thus, to the extent the Chairman's proposal creates a direct tax that is not a true "income" tax, it is open to attack on constitutional grounds.

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[3] Article I, Sec. 9 provides: "No Capitation, or other direct, tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

[4] The 16th Amendment provides: "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census and enumeration." [Emphasis added].

[5] Bittker, 1 *Federal Taxation of Income, Estates and Gifts*, ¶ 1.2.3 (1981)

The nondeductibility proposal is the antithesis of the entire tax framework based on a tax on net income. In fact, the more tariffs you pay, the higher your tax bill would be. This is not only a tax on a tax, it is a tax that increases as the taxes you pay increase, surely something that the Red Queen in Alice in Wonderland could understand, but not someone trying to devise a rational tax system.

2. The Chairman's Proposal Will Have Adverse Domestic Economic Effects

A radical change in U.S. tax policy, such as that proposed by the Chairman, requires the most careful and sober analysis of its economic consequences. Such analysis would undoubtedly show the proposal to be costly, inefficient and inequitable--the opposite of what is desired from tax reform.

The principal domestic economic effect of disallowing the deductibility of tariffs as ordinary and necessary business expenses is to increase sharply the "effective" or "real" tariff burden without changing nominal tariff rates. The increased tax burden resulting from nondeductibility is roughly equivalent to a 54 percent increase in the real cost of tariffs.[6/] The effects of higher real tariffs are twofold. First, the higher real tariff distorts the structure of relative prices as among different goods and as between imported and domestically produced products. It does not provide us with the level playing field we are all seeking. On the contrary, it would result in a misallocation of resources, a loss of efficiency in the economy, and, ultimately, lower productivity and a slower rate of economic growth. Second, by distorting relative prices, a higher real tariff will increase the price paid by consumers and contribute to inflationary pressure, aggrevating our current problem of rising import prices as the dollar falls.

Quantifying these effects is not easy, and a serious research effort should be made before the proposal advances. We

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[6/] Under the current 46 percent maximum corporate income tax rate, the "net tariff" paid by importers (after deducting tariffs paid from gross income) is 54 percent of the nominal amount of the tariff. Even assuming that the proposed 35 percent corporate tax rate were enacted, the "net tariff" paid would be 65 percent of the nominal amount. If the tariff deduction were disallowed, the "net tariff" would be 100 percent of the tariff, or an increase in the cost of the tariff to the importer of 54 percent.

do know, however, from our own industry experience, that voluntary export restraints on automobiles by Japan, which act in some ways like a tariff, have had the effect of increasing consumer prices for imported cars by $1,000 to $2,000 in some years.[7] Obviously, disallowing the deductibility of tariffs over the entire range of dutiable imports can have a substantial impact on consumer prices.

The Chairman's proposal on tariff nondeductibility will have a major impact on consumer prices in the automobile sector. Given the relatively inelastic demand for imported automobiles, it is certain that additional tax burdens on importers and cost increases to dealers will be passed through, in large part, to individual consumers. Buyers of imported light trucks, which are subject to a 25% tariff rate, will be

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[7] See "A Review of Recent Developments in the U.S. Automobile Industry Including an Assessment of the Japanese Voluntary Restraint Agreements", U.S. International Trade Commission Publication No. 1648 (February, 1985), which pointed out that consumers paid an extra $8.52 billion in 1984 due to the Japanese Voluntary Restraint Agreement, broken down as follows:

Higher prices on Japanese automobiles...	$ 3.3 billion
Price increases on U.S. domestic automobiles..........................	$5.22 billion
	$8.52 billion

See also "Aggregate Costs to the United States of Tariffs and Quotas on Imports: General Tariff Cuts and Removal of Quotas on Automobiles, Steel, Sugar, and Textiles", David G. Tarr and Morris E. Merkre, Bureau of Economics Staff Report to the Federal Trade Commission, December, 1984, which had somewhat lower costs regarding annual costs to U.S. consumers due to the VRA.

particularly hard hit. The average landed cost of these vehicles to the importer is approximately $4,000, resulting in tariff liability of $1,000 per vehicle. If the importer is unable to deduct that fixed cost, the loss of deductibility, even at the proposed 35% maximum corporate tax rate, will result in an increase in cost to the consumer of over $500 per truck. Automobiles are subject to a much lower tariff of 2.6%. Again, assuming a 35% corporate tax rate, the resulting increase in cost of an average-priced automobile (assuming an average landed price basis of $7,000) will be approximately $100.[8/]

The adverse price effects, however, do not stop with imported products. The proposal will cause higher prices for domestically-produced goods as well. This is particularly true in automobile industry where the lessons of the Japanese "Voluntary" Restraint Agreements (VRA's) have taught us that domestic automakers will take immediate advantage of import restrictions by raising prices. Thus, the the Chairman's proposal would raise the cost of automobiles across-the-board.

If prior experience involving trade restraints on automobiles is any guide, the domestic automobile industry could be expected to raise its prices by over $1 billion, following the price increases of imported automobiles attributable to tariff

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8/ The calculation of the dealer's increased costs is based on the assumptions of the proposed 35 percent tax rate and a full "pass-through" of the increased cost to the importer. It also takes into account the increased revenue associated with the pass-through and the additional tax liability on that revenue.

non-deductibility. It is crucial to note that this $1 billion will be collected by the domestic automobile oligopolists, and not the Federal Government. The tariff non-deductibility proposal will provide windfall profits to swell the coffers of such needy corporate giants as General Motors and raise prices to the U.S. consumers of automobiles, already burdened by dramatic price increases in recent years.

In general, price increases will tend to ripple throughout the productive sectors of the U.S. economy in proportion to the amount of imported inputs each sector uses (and in proportion to its use of inputs of items subject to excise taxes). For example, both agriculture and retail delivery services, which use light trucks extensively, will experience increased production costs and pressures to raise their prices.

Ultimately these increased costs and prices will have an impact on U.S. export industries, impairing their international competitiveness and worsening an already grotesque trade deficit. Tax policy should be framed to improve, not impair, U.S. international competitiveness. But a tax on imports, which is what nondeductibility amounts to, is ultimately a tax on exports.

There are other adverse domestic economic effects that should be considered. Tariffs are regressive taxes and an increase in the "real" tariff rate increases the regressivity. For example, imports of low cost footwear, already burdened by tariffs of 6%-20%, and purchased mainly by low income consumers, would become more costly. Removing deductibility would also create an arbitrary and unfair distinction between products protected by tariffs, and products subject to quantitative restrictions. Importers of products subject to tariffs would find an increase in their taxes and importers of products subject to quantitative restrictions would find their taxable income unchanged.

Moreover, the revenue effects of removing deductibility may well be overstated. To the extent that the increase in the "real" tariff burden shifts demand to domestic products and other goods, the taxable base for collecting additional revenue shrinks. The same point applies to increases in the real burden of excise taxes paid by business.

Most importantly, by increasing the price wedge between imported and domestically produced products, this proposal is an open invitation for domestic producers to increase their own prices and reap unearned windfall profits.

3. Eliminating Tariff Deductibility Would Have Adverse International Trade Consequences

The Chairman's proposal is also bad international trade policy. Were the proposal to be enacted, the resulting legislation would constitute only slightly veiled protectionism. Indeed, adoption of the plan would increase effective tariff rates by 54 percent. Such a result would be in violation of specific U.S. obligations under the General Agreement on Tariffs and Trade (GATT) and could trigger widespread retaliation by our trading partners. In light of the upcoming multilateral trade talks, this is a particularly inappropriate time for the U.S. to enact such legislation.

A key objective of the next round of trade negotiations is the reduction of barriers to trade. What credibility could the United States possibly have to seek the reduction of foreign tariff and nontariff barriers to trade to promote U.S. exports after it had just implemented an effective tariff increase of 54 percent? Our United States Trade Representative has set as a goal for the developed countries the elimination of tariffs to the maximum extent feasible in the next round.9/ Eliminating the deductibility of tariffs in the United States will make this objective much more difficult to achieve.

The large increase in effective tariff rates would undoubtedly cause considerable contraction of international trade and, as discussed above, it will inevitably result in higher prices to U.S. industrial and individual consumers. In addition, the effective increase in tariffs would be contrary to U.S. commitments under the GATT and would negate specific concessions granted by the United States in the Tokyo Round of GATT Multilateral Trade Negotiations (1973-1979).

As the Senate Finance Committee well knows, the GATT was created in 1947 as an agreement among nations to uphold certain

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9/ See Bart S. Fisher, "Making the World Trade Regime Work: An Agenda for GATT", Vol. 6, SAIS Review (Winter-Spring, 1986).

principles. Three fundamental principles of the GATT that would be violated by the non-deductibility of tariffs proposal are:

(a) the binding of tariff concessions and the provision of compensation following the modification of duty schedules;

(b) national treatment; and

(c) the proscription against the nullification and impairment of prior tariff concessions.

The Binding of Tariff Concessions and the Modification of Duties

The procedure for tariff negotiations is well known to this Committee. Following a delegation of tariff-cutting authority, the President, in a multilateral context, makes certain tariff concessions in order to achieve reciprocal concessions from our trading partners. These tariff concessions are enshrined in the GATT Schedule of Concessions, which constitute the formal tariff accord between the United States and its trading partners. Article II of the GATT provides that products "shall . . . be exempt from ordinary customs duties in excess of those set forth [in the Schedules of Concessions]" and that "[S]uch products shall also be exempt from all other duties or charges of any kind imposed on or in connection with the importation in excess of those imposed on the date of this Agreement. . . ." The non-deductibility proposal is an across-the-board effective increase in tariffs after the date of the last tariff agreement, i.e., the 1974-1979 Multilateral Trade Negotiations. As such, it appears to violate the prohibition under Article II on charges imposed "in connection with importation" which exceed agreed upon tariff concessions.

The tariff non-deductibility proposal also amounts to the unbinding of formerly agreed upon tariff concessions, and a modification of U.S. duty schedules. Article XXVIII of the GATT, "Modification of Schedules", provides that, when schedules are modified:

> In such negotiations and agreement, which may include provision for compensatory adjustment with respect to other products, the contracting parties concerned shall endeavor to maintain a general level of reciprocal and mutually advantageous concessions not less favorable to trade than that provided for in this Agreement prior to such negotiations.

Is this Committee prepared to launch the U.S. Government into a set of trade negotiations that would require the United States to offer "substantially equivalent concessions" to our trading partners to compensate for the adverse effects of the tariff nondeductibility proposal, as may be required by Article XXVIII(3)(a) of the GATT? Finally, Article VII of the GATT calls for the maintenance of stable customs valuation schemes by GATT signatories. By shifting the tax treatment of tariffs, the United States would be changing its system of customs valuation and could be violating Article VII of the GATT as well.

National Treatment

Similarly, the proposal appears to be inconsistent with Article III of the GATT, which prohibits subjecting imports "directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products." Article III also states that the imports "shall be accorded treatment no less favorable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use."

By selectively eliminating business deductions for tariffs and excise taxes, the Chairman's proposal effectively imposes charges in excess of those applied, directly or indirectly, on domestic like products. Limiting nondeductibility to tariffs and excise taxes will subject foreign goods to special hardships as compared to goods of U.S. origin. In essence, the Chairman's proposal protects domestic industry at the expense of imports, which is precisely the kind of national practice that Article III was intended to prohibit.

Nullification and Impairment

Articles II and III reflect fundamental GATT principles. The inconsistency with these basic proscriptions, even if not found to be a specific GATT violation, will undoubtedly lead to retaliation by our trading partners. Moreover, GATT permits formal retaliation under Article XXIII, in the case of "nullification and impairment" of benefits. In particular, Article XXIII provides for consultations and eventual "compensation" if any benefit accruing to a party "is being nullified or impaired or. . . the attainment of any objective of the Agreement is being impeded. . ." A measure taken by a member country can be actionable under Article XXIII even if it is not in violation of any other provision of the GATT. This is called a "nonviolation" nullification and impairment of the GATT. Thus, even if it is determined that nondeductibility does not violate Articles II or III, U.S. trading partners could still claim nullification and impairment under Article XXIII to escape bilateral and mulitlateral commitments and thereby increase tariffs on imports from the United States.

The denial of tax deductibility of $2 billion worth of tariffs currently being paid by the imported automobile industry would nullify and impair the benefits of the prior tariff concessions granted on automobiles and trucks and violate Article XXIII of the GATT.

Use of Article XXIII, as well as more informal unilateral retaliation, would reverse nearly 40 years of U.S. efforts to reduce tariff barriers to trade. During the Tokyo Round, the United States and its principal trading partners agreed to tariff cuts averaging about 33 percent for developed countries (30 percent for the United States), phased in over an eight-year period. The mutual tariff concessions were intended, among other things, to reduce tariff disparities with Canada in export-oriented industries, reduce Japanese tariffs on a variety of products, and decrease the level of preference inherent in the growing free trade area in Europe through substantial reductions in European duties. As our trading partners come to appreciate the adverse ramifications the effective increase in the U.S.

tariff rate will have on their export opportunities, they are certain to consider retaliating against U.S. exports. One likely form of retaliation would be for other countries to emulate the new U.S. policy of increasing effective tariff rates by disallowing the deductibility of tariffs.[10]

Enactment of the Chairman's proposal would be particularly inappropriate at this time. First, it would be erecting a trade barrier virtually indistinguishable in effect from the Japanese excise tax provision that the United States is challenging under Section 301 of the Trade Act of 1974 (Investigation No. 301-50). In September, 1985, the President directed the U.S. Trade Representative to self-initiate an investigation of Japanese barriers to trade in tobacco products. One of the barriers being investigated is the discriminatory manner in which Japanese excise taxes on tobacco products are imposed. Before the Japanese tax is computed for U.S. and other imported tobacco products, the costs of shipping and import duties are added to the value of the product; in effect, a tax on a tariff. This discriminatory tax thus makes imported products relatively more expensive than Japanese tobacco products. The Chairman's proposal similarly places a tax on a tariff and raises a tariff barrier to imports by denying the deduction for duties paid.

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[10] In addition to deviating from current U.S. tax policy, the Chairman's proposal is at odds with the current tax practice of the majority of our trading partners. Japan, Mexico, Canada, and most European and East Asian countries permit the deduction of all tariffs and customs duties as business expenses under their respective tax laws.

Also, as noted above, this proposal could seriously impede U.S. efforts to further reduce tariff and non-tariff barriers to trade in the upcoming multilateral trade talks. The United States initiated the preparatory process for these negotiations last Fall and has taken an early lead in promoting an agenda which seeks increased trade liberalization. The implementation of a tax law which discriminates against imports will undercut our efforts to persuade other nations to dismantle their own barriers to trade.

Conclusion

In summary, the Chairman's proposal to eliminate the deductibility of tariffs and excise taxes is a major departure from longstanding U.S. tax policy which would unfairly burden particular sectors of the economy, vastly increase costs to business and consumers, and provoke an adverse reaction from our trading partners.

Elimination of deductibility for tariffs also raises broader concerns of constitutionality and would undermine U.S. commitments under the GATT and the trade agreements concluded during the Tokyo Round of Multilateral Trade Negotiations.

The Tariff Act of July 4, 1789 was the first substantive piece of legislation passed by the First Congress. We urge the Congress not to use non-deductibility of the tariff as the first substantive step in undermining the just application of the income tax system of the United States. Most emphatically, we urge the Committee to consider the international obligations of the United States and the threat posed by the tariff non-deductibility proposal for the continued U.S. leadership role in the international economic arena.

STATEMENT OF JOHN K. MEAGHER, VICE PRESIDENT, GOVERNMENT RELATIONS, THE LTV CORP., WASHINGTON, DC

Mr. MEAGHER. Thank you, Mr. Chairman. My name is John Meagher. I am a vice president of Government Relations for The LTV Corp., and I am pleased to be here today to have an opportunity to testify in behalf of the chairman's proposal to eliminate the deductibility of tariffs.

We think that this provision is an important step in the leveling of the international playing field. We endorse it, and we recommend its retention in this legislation. The leveling of the international playing field is made up of a number of factors, but one of the key factors in the studies that we have done, both in my company and in the Basic Industry Coalition which I head, is the cost that is associated with taxes.

The relative tax systems in the world today basically do not encourage American products. They discourage them. Our own tax system is a system that ignores the reality of the international marketplace. It subsidizes imports and discourages exports because it doesn't tax imports; nor do producers of products pay taxes in their own country on exports. The result is a major cost differential to us—us being domestic manufacturers—in the neighborhood of 20 to 40 percent, depending on the goods involved and the country of origin.

One of the elements in this situation and the fact that we don't tax imports is the nondeductibility of tariffs. What happens is that the United States gets at most 50 cents for every dollar of tariff that is levied. I assume if the International Trade Commission decided that there ought to be $1 of tariff levied on a certain product, it did so with the idea that that level would enhance a certain level of protection.

When you allow the deductibility of tariffs, obviously that level of protection is cut in half. What in fact we are doing in this country is subsidizing imports to the point of $16 billion. In the case of American steel, we are subsidizing it to the extent of $.5 billion. This at a time when 25 percent of our market is made up of imports and we have a trade deficit of $150 billion and the bulge of imports are hurting every sector of this economy.

It isn't just steel; it is autos, it is semiconductors, it is rubber, it is chemicals. Go right down the list of your constituents of the industries that are represented in this town, and they are going to be impacted by imports.

What will happen if the chairman's proposal is enacted is that the prices will rise; and the consumers will be hurt. Well, it should be pointed out that consumers pay one way or the other. They either pay through the loss of their jobs; they pay through the loss of income; or in fact, when domestic manufacturers are put out of business by imports, they pay through the marketplace. The other place they pay very simple is they pay through the Tax Code. Tax rates are higher as a result of the fact that $16 billion in tariffs are being deducted.

And the question that we have to ask ourselves is: What kind of a tax system do we want? Do we want one that has a broader base with lower rates? Or do we want to continue the kind of deductions and subsidies, in effect, to imports which the nondeductibility of tariffs under the existing law provides. In addition to that, it should be pointed out that our trading partners, most of which have a VAT—in other words they receive the full payment of the VAT—and then in addition to that, they obtain the funds from tariffs.

What we get is half the value of our tariffs. It hardly seems a fair situation. The way we look at this, Mr. Chairman, is part of an important step in promoting the international fairness in the Tax Code. We think very honestly that the worldwide economic situation demands that we tax imports to a much greater extent than we do.

In fact, we would go further than your proposal; and we would support and have supported—and I have testified here about it—the kind of concept that Senator Roth has promoted for a business transfer tax, or some sort of a mechanism that deals with the question of the comparative value of taxation between this country and other countries.

And we think that if you don't do that at some point, and the sooner the better, that in fact what will happen is that our standard of living will be reduced down. You look at those communities around the country where our steel mills are or were, and you see the standard of living going down. One of the main reasons they are going down that we don't have a level playing field, and our people are operating under a disadvantage.

Your proposal is, in our view, an important step toward the ultimate goal of leveling that playing field. We think that it ought to be done now. We think it is fair for America, for its consumers, and for its workers. We think that the elimination of this provision is an important concept that you ought to embody in your bill.

For that reason, we support it.

[The prepared written statement of Mr. Meagher follows:]

TESTIMONY

OF

JOHN K. MEAGHER

VICE PRESIDENT-GOVERNMENT RELATIONS

THE LTV CORPORATION

SENATE FINANCE COMMITTEE
April 21, 1986

Mr. Chairman, my name is John Meagher. I am Vice President for Government Relations of The LTV Corporation. LTV is a diversified operating company in steel, aerospace and energy products. We are glad to have the opportunity to testify on the Chairman's proposal to eliminate the deductibility of tariffs. In our view, it is an important step toward leveling the international economic playing field. We endorse it and urge its retention in this legislation.

While the proposed legislation being considered is in the context of tax reform, there are other, equally important trade aspects to it which give validity to the Packwood package. It is to this that I wish to direct my remarks.

In a very real sense, the tax reform legislation being marked up presently is the most important legislation vis-a-vis the ability of American business and agriculture to compete to be considered in years. What is at issue here is not simply whether we have lower tax rates, but, at the bottom line, whether our cost of production is going to be higher or lower than the cost of production of our trading partners. It is that which ultimately determines our ability to compete, and this legislation will have a direct impact on that cost.

Historically, our cost of production has been higher than those with whom we compete. In many instances, this is due to subsidies on the part of the foreign government. These range from the building of factories to tax breaks and low-interest loans. While many of these subsidies are hard to prove because of their arcane nature, many are provable under our current trade laws and have become the basis for quotas, tariffs, etc., being imposed on foreign goods. Efforts to end these subsidies should continue, but, in my view, this will be a losing game for America since by the time they are provable, the damage has usually been done and the domestic industry is in serious trouble.

The other problems of basic industries in America, unfortunately, are grounded in our own domestic policies. These policies, it should be noted, were well intended and usually designed to deal with a specific social or economic problem on which there was national agreement. However, more often than not, they had ancillary results that contributed to the decline in domestic competitiveness.

Briefly, they include:

1. Environmental laws. America has spent over $800 billion on environmental protection. While these laws are valuable and highly supported by the American people, there is no denying their impact on the cost of production here. Few countries with which we are competing have these so their industries have a cost advantage.

2. Anti-trust laws. Historically, our anti-trust laws have been grounded in the notion of determining competition based solely on the domestic market. As a result, American industry has been denied the right to achieve efficiencies of cost by mergers whereas, in other countries, this isn't the case. The Administration's recent recommendations on anti-trust reform represent a major step in the right direction in this respect.

3. Social Insurance Laws. In most of the industrialized countries, extensive public social insurance programs funded by a VAT are in place. In Third World countries, few programs of this type exist. In contrast, in America, social insurance programs are paid for half by government and half by business. (This assumes a 50% corporate tax rate). However, the costs of health insurance, disability, pension, etc., are a major cost factor to American business, and as our population grows older, it will be an increasing burden. At LTV, we have two people on pension for each worker.

4. Credit Policies. The cost of capital in the U.S. is twice as high as in Japan and one-third higher than in Western Europe. With few exceptions, our government does not subsidize credit directly (it does so indirectly through the tax system) whereas in the countries with which we compete, direct credit subsidy is a way of life and a major governmental function.

5. Adjustment Policies. Since the demise of the Trade Adjustment Assistance programs for individuals and firms, we have no meaningful adjustment policies. As a result, many businesses retain obsolete capacity for too long thus lessening productivity and keeping operating costs high. In contrast, in most foreign countries one of two actions occur. Either the government directly subsidizes the industry which has excess or outmoded capacity since this is cheaper than the cost of putting workers on the social insurance program, or they pay the industry to shut down. We do neither. Recently, Congress nearly went in the opposite direction by almost enacting plant-closing legislation.

6. Foreign Assistance Programs.
Well-intentioned expenditures such as IMF and World Bank and Ex-Im Bank loans helped our competitors but hurt our domestic industries. Essentially, American tax dollars have been used to build foreign capacity which builds cheap goods for export to the U.S. market. These, in turn, compete with domestic products which are taxed and receive little or no subsidy.

7. Imports. Imports of steel since 1981 have risen to a level of about 25%, and the average price of a ton of American steel has declined over $100 today. Succeeding Administrations have supported cheap, government-subsidized imports and allowed world-wide steel capacity to rise. The confluence of these two developments has meant that American steel capacity has shrunk while foreign capacity has grown or remained constant. In short, because of our open market, foreign workers are replacing American workers and foreign governmental subsidies are increasing as domestic steel profits have disappeared.

8. Tax Laws. We have a tax system in this country which simply ignores the reality of the international marketplace. It encourages imports and discourages exports because it fails to tax imports while taxing domestic manufacturers -- and taxes exports which are taxed again overseas. In addition, most exporting countries do not tax exports -- at all -- with the result that goods entering the U.S. enjoy a huge cost advantage over domestically produced goods. We estimate the cost advantage from taxes alone to be between 20% - 40% depending on the country of origin and the product.

These are the major factors which increase our cost of production over our trading partners. There are others but these are the main ones.

Until we come to grips with the variances caused by these policies, we will continue to lose our ability to compete not only overseas but here at home. But, "coming to grips" doesn't mean eliminating or severely reducing environmental laws or pension programs, for example. Americans want and need both, but we must take a long-range view of how the variances between our laws and "theirs" impact on cost of production and consider changes, where appropriate, to change our laws. Such a course change will not and cannot be done quickly. It will take years and will necessitate a change in mind-set about commerical relations.

Ultimately, we need to enact a new tax system, for example, which taxes imports and subsidizes exports, that encourages savings and penalizes consumption, that is fair for all who do business or enjoy the fruits of America, not just those with a plant or store here.

We need some relief in the pension area or it will choke American companies. Again, this must be done carefully and over a period of time.

We need to consider subsidizing domestic credit for business expansion as we do foreign industrial expansion.

While few of these policies can be changed to provide short-term relief, Chairman Packwood's draft in general is an important step toward that goal. The depreciation provision recently adopted by the Committee recognizes that we can't increase our cost of capital and remain competitive. The ITC Redemption provision would insure that companies and individuals would not be penalized vis-a-vis their foreign competitiors nor that taxpayers already hurt by imports would take a further hit. Finally, the elimination of the deduction for tariffs ends one of the subsidies we have been granting imports. It is change which can take place now and begin to change the relative cost of production I mentioned.

Under existing law, our government gets, at most, $.50 for every $1.00 of tariff imposed. As an economic matter, we are subsidizing imports from this one provision in the law by $16 billion. In the case of steel, the subsidy is over $1/2 billion. Such a provision makes no sense at a time when our trade deficit is at $150 billion and every sector of our economy is hurting from the bulge of imports.

As I said at the outset, we endorse this provision. We wish, frankly, that the Committee would extend the philosophy which underlies it further. We believe that imports generally should be taxed to a much greater extent. Previously, I testified here on why we support a border tax or variation on the concept of Senator Roth's Business Transfer Tax (BTT). I won't repeat myself except to say that we favor a policy which will require imports to pay in order to play. America stands virtually alone in the world in not, in any effective way, protecting our domestic markets. Most countries do this by either major import barrier or taxation. We favor the latter. We view the taxation of imports as a major alternative to protectionism (quantitative restraints) and the most effective way to guarantee the continuance of an open-trading system and consumer choices.

The elimination of the deductibility of tariffs is important in this context and should be supported. We believe it represents a meaningful policy change which is necessary and long overdue.

The CHAIRMAN. Senator Long.

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. No questions right now, Mr. Chairman.

The CHAIRMAN. Mr. Donohue, how much would the average price of a Nike shoe go up under this proposal? What does your average shoe retail for now?

Mr. DONOHUE. The average shoe retails for $33.

The CHAIRMAN. And what do you think this would raise it to?

Mr. DONOHUE. That is a difficult question. Mr. Chairman, I would assume it would be on the order of $4 or $5 that would be passed on.

The CHAIRMAN. That is more than $4 or $5 to you, but you are assuming the multiplier factor that goes through the different chains until it gets to the retailer?

Mr. DONOHUE. Yes, I am, Mr. Chairman.

The CHAIRMAN. Mr. Meagher, countervailing duties and anti-dumpting duties, are they currently deductible?

Mr. MEAGHER. Yes, they are; and I think that that is ridiculous.

The CHAIRMAN. We can levy penalties on companies for violating our laws, and then say that you can deduct them, anyway.

Mr. MEAGHER. Thank you for my answer. That is right. That is exactly right. What happens is that we bring unfair trade cases against subsidized products or dumped products; and then, in the wisdom of, for example, the International Trade Commission and then the President of the United States who has ultimate say over the remedies involved—those duties—or in the case of a court—those duties are in fact cut in half by the deductibility of tariffs.

Mr. HANDAL. Mr. Chairman, may I comment on that?

The CHAIRMAN. Yes.

Mr. HANDAL. I understand the point you are making, but one must look at the incidence on the tax, on whom will it fault? It is not just a matter of punishing foreigners for doing something wrong. In a case like that, it would be the American consumers, the American manufacturers, and the American importers that would suffer.

Mr. MEAGHER. Mr. Chairman, if I could comment on that?

The CHAIRMAN. Go ahead.

Mr. MEAGHER. There is one category that has been noticeably left out in his statement, and that is what about the domestic American manufacturers, who may not bring a lot of goods into this country? They are the ones that are really disadvantaged by the deductibility of tariffs.

Of course, the importers may be impacted, or they wouldn't be here today. I guess I wouldn't be here if I weren't on the other side.

But in addition to that, the exporters might be harmed, but the domestic American manufacturers are the ones that are really harmed by this.

The CHAIRMAN. Let me ask you and Mr. Handal this. We are trying to get corporate rates down to 35 or 36 percent; and yet, we are faced with about a $100 billion expense to do some of the things the President has requested be done, over the House bill. One, where should we get the money?

Two, would it not be a fair tradeoff to eliminate the deduction of excises—tariffs are a fair size, but a relatively small part of the total—in exchange for getting the maximum corporate rate down to 35 percent? We can start with Mr. Handal.

Mr. HANDAL. If I could answer your first question, I think I would be running for Senator from New York, which is where I live. I am afraid I have no answer to how to balance one with the other. When you go into excise taxes, the expertise that I have is in terms of tariffs. So, I would prefer to talk about that.

And one of the things that I think we can't lose sight of is—Mr. Meagher talks about a level playing field and that kind of thing—it is going to affect American exporters tremendously as well. In your own State, there is a lot of high-techonology business. A lot of the products that they try to export or sell in the United States, for that matter, have components that are imported. And there are a lot of effects of this kind of thing. It is not a very simple sort of a change that we are talking about. One of the points in my testimony was that I think it requires some very, very careful study.

The CHAIRMAN. Mr. Meagher.

Mr. MEAGHER. I think I have said about all I need to say, Mr. Chairman, in that respect. What it does obviously is to increase the domestic price. And in so doing, in our view, it will make it more possible for American products to compete in America. As the gentleman says, there are a lot of high-technology products—shoes, et cetera—in addition to basic industry products that are exporting a lot.

But if you look at the marketplace today, the difficulties from imports are not just in the basis industries like steel or mining. They are in those products as well, and you really have to look behind that question to determine what are the reasons for our inability to compete.

It certainly isn't only tariffs. Tariffs are a minor factor in our ability to compete. We have to go further than that. That is why we endorse your proposal, but I wish you would do more. We think that you have got to go to a broad-based tax to level the playing field vis-a-vis the whole panoply of imports into this country. And unless you do that, you are going to see a lot more steel industries in this country and a lot more chemical industries, and a lot more iron ore and coal industries that are having infinite difficulty.

And at some point, it will be the Nikes that will be in those situations.

The CHAIRMAN. Senator Matsunaga.

Senator MATSUNAGA. No questions, Mr. Chairman.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. I would like to get back to the Nike situation, Mr. Donohue. As I understand your testimony, the lack of deductibility of the import fees will increase the price of the shoes you sell. But I am not sure of the next step. Is it your point that because that will occur, fewer pairs of shoes will be sold in the United States?

In other words, it seems to me that in this case—in your particular case—we do have a level playing field in that the excise tax that we are talking about is the import fee not being deductible, and that would apply whether Nike made their own shoes or imported them or your competitor imported all his shoes. So, isn't it equal for everyone, unlike perhaps Mr. Meagher's situation so that, when you are through, the shoe is going to cost, instead of $15.68, it is going to cost $16.20?

Mr. DONOHUE. Not the Nike shoes, Senator, because quite frankly, we are not at the low end of the marketplace. We know that the market is price-sensitive, and so the Nike shoe, which is a quality athletic performance shoe, does not compete with a volume shoe, canvas-type, that is not our competitor. And so, as we are priced out of the market, yes, people will buy shoes. They just won't buy Nike shoes or quality athletic goods. They will buy a cheaper shoe.

Senator CHAFEE. You are saying that, because the excise tax will go on your shoe, which we are assuming is an imported shoe—is that right?

Mr. DONOHUE. Yes, sir.

Senator CHAFEE. And that will increase the price of it so that people won't pay that extra amount for the quality shoe?

Mr. DONOHUE. We always know that there is price sensitivities in each of the products. And so, if we market a product at $29, we know that if it goes to $30 for some reason, the consumer is intuitive enough and will not pay that value.

And so, all the way up in our line of shoes that run up to as high as $70, $80, $90, or $100. There are price-sensitive points. We clearly—as in the market with all competitors—if the market could absorb a higher price, it would have it because all producers would charge a higher price.

Senator CHAFEE. But isn't this a case where you might say it is a mandated increase, like if social security went up? And it is going to affect everybody the same. We have got to assume that domestically made shoes are more expensive.

Mr. DONOHUE. Certain of them are.

Senator CHAFEE. And so, thus, if it is a nondeductibility of the import fee, that is going to increase the price of all imports. Is it that people would then buy fewer shoes?

Mr. DONOHUE. No.

Senator CHAFEE. Or you say they would drop to a lower——

Mr. DONOHUE. They would drop to a different quality of shoe, a type of shoe that we do not make; and there are volume type providers who make a canvas-type shoe that is readily available in the Safeways and K marts.

Senator CHAFEE. And imported?

Mr. DONOHUE. Frequency imported; yes.

Senator CHAFEE. But aren't they subject to the same? Their price is going to go up, too; so the differential between the brand X and Nike is going to remain roughly the same, isn't it?

Mr. DONOHUE. It should.

Senator CHAFEE. So, therefore, I don't understand why everybody switches down to brand X from yours.

Mr. DONOHUE. If I could explain to you why the change of the price of a dollar in a shoe will make it either marketable or not marketable, I would understand better myself; but quite frankly, price sensitivity in the marketplace is intense, and we are all aware of it.

Mr. HANDAL. Mr. Chairman, could I address that?

The CHAIRMAN. Go right ahead.

Mr. HANDAL. I am a jogger. I don't happen to wear Nike, I am sorry to say; but I am willing to pay only a certain amount of money for a pair of shoes.

Senator PRYOR. You will have a pair tomorrow. [Laughter.]

Mr. HANDAL. I hope so. I am only willing to pay a certain price for a pair of shoes. If the price——

Senator CHAFEE. And I will bet that is a good price.

Mr. HANDAL. Yes, it is. I happen to be at the higher end of the market; but if the price goes up beyond that price that I am willing to pay, I would trade down to something close to the price that I had been paying, which now would be a lesser quality.

My company, on the other hand, is in the lower end of the business—not in the shoe business—but for example, the example in my testimony is about gloves, infants' and toddlers' gloves, or mittens. And in that example, we would have to increase our price. There is no domestic competition on something like that. So, to your point, Senator, everyone else that is importing or selling that particular glove would be faced with precisely the same tax situation that we would be. So, everybody's prices would go up the same.

Senator CHAFEE. Let me just say this. As you all know, if you have sat here today, you know that I am not in favor of this because I am not in favor of using tax increases to pay for tax reform. I am for using tax increases to reduce the deficit. In sympathy for the chairman, who probably doesn't need an awful lot of sympathy—he can stand on his own two feet—but the tale of woe that has been heard here today that the American trucking industry is going to grind to a halt, that we are not going to sell any shoes, that the roof is going to cave in on America because of this nondeductibility of excise taxes that can't be passed along, I think is somewhat overdone.

Now, I am on your side in connection with this proposal; but the idea might come up again in connection with raising more revenue. I am just not sure that the United States is going to grind to a halt if these were made nondeductible; but in any event, you gentlemen feel strongly about it. Everybody who comes here before us feels strongly about their matter.

Mr. MCELWAINE. Mr. Chairman, may I comment on Senator Chafee's remarks here? I don't think all of us have come here to say: Don't tax me; tax the other guy. I feel that if you put your question and the question that the chairman asked a little bit earlier to the 7,500 small businessmen who constitute our membership, that they would tell you that they would be happy to pay a little more tax to help solve our tremendous deficit problem.

They object strenuously to a kind of convoluted system which would raise the price of their products substantially and thereby destroy their own competitive stance in the marketplace. But if you went to them and said: "Our country is in trouble, and we have got a deficit we can't handle, we would like to raise your taxes a little," they will reach for their checkbook.

I think one of the problems that we really have in dealing with our tax problems, with this terrible hydra-headed monster that the chairman and this committee are wrestling with, is that we have a lack of confidence in the capacity of the American people to make sacrifices when sacrifices are asked of them in a fair and equitable manner.

And I strenuously urge on this committee that they take that into consideration, Mr. Chairman.

Senator PRYOR. Mr. Chairman.

The CHAIRMAN. Let Senator Chafee finish; and Senator Durenberger next.

Senator CHAFEE. I agree with you that this is an odd proposal, and I don't think it is one that I support, as I have said. And I think that it is possible to raise taxes in America and get more money if it is done across the board.

One of the reasons I am for tax reform is that if we are going to have an increase in taxes, I think it ought to be based on a fair system so we are not compounding inequities that currently exist under the code. What we are trying to do here is to try and make the system fairer. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Mr. Chairman, I just thank the Lord that the Senator from Rhode Island isn't mad at me, and I well recall the time in his 1982 campaign when he was being attacked for being—I think it was—or something—and he told us all the wonderful story about the statue that is on top of the capitol building in the capitol of Rhode Island, which is dedicated to the independent man. Right?

I think the Senator certainly exemplifies that here.

Senator CHAFEE. I am waiting for the other shoe to drop. [Laughter.]

Senator DURENBERGER. We have the same position on the tax principles involved here; and unfortunately, I wasn't here all day long to find out which industries will be destroyed because of the failure principle.

Now, here is an industry that is already dying or dead, and Mr. Meagher has been representing them for many years, since he left the Ways and Means Committee. And we try to do principal things, as you know, Mr. Meagher.

Mr. MEAGHER. Yes, sir.

Senator DURENBERGER. Safe harbor leasing, the refundable investment tax credit with the Senator from Louisiana; and I think in each of those cases there was a sense of principle behind it.

And as I recall, at least as I came to the issue, it was largely from the standpoint of basic industries, industries in which the failure to make a profit was not necessarily indicative of the failure of the skills of management or anything else in a company. So, I have some sympathy for the fact that not everyone in a lot of industries in this country can be tax profitable every year.

But as I listen to your testimony, I am curious to know how LTV and perhaps others in the fuel industry who have talked to me and others about this issue—how do you view the imposition of a 35 percent tax, roughly, on the payment of tariffs and excise taxes, notwithstanding whether the company actually has any taxable income or not? How would you look at that?

Mr. MEAGHER. We pay Social Security taxes. We don't get to deduct them because they don't have any tax liability.

Senator DURENBERGER. We all pay that.

Mr. **Meagher**. We all pay that. We pay other excise taxes.

We pay severence taxes. We pay a whole panoply of taxes. And one of the fallacies of companies that don't make any money is that they don't pay taxes. In the case of social security and those taxes, we pay 100 cents on the dollar because we can't get to deduct them.

Senator **Durenherger**. But if you were a steel distributor in the same financial condition as LTV is, as a fabricator or manufacturer, and you were tough competition and all that sort of thing and you had the years of loss that you had, how would you feel about having a 35 percent tax added on to the cost of your product?

Mr. **Meagher**. Senator, I don't——

Senator **Durenberger**. Would you like that policy?

Mr. **Meagher**. I don't like any tax added on to the cost of the product because it does in fact give me a difficult position vis-a-vis my competitiveness; but in the case of tariffs, it is a question of who wins and who loses. In this instance, where you are talking about the deductibility of tariffs on products, the question is: Who is the winner?

The winner in this case is the person than doesn't import a lot. They are the clear winners. The loser is the person that imports a lot.

Senator **Durenberger**. Did you state previously where the tax principle was in the chairman's proposal? Do you find some good tax principle in that?

Mr. **Meagher**. I think that the principle—the tax principle—involved in his proposal is, in our view, that you need to tax imports to a much greater extent that you do today. I think that, as Roger Mentz pointed out this morning, there is a question of external social costs involved. The external social costs for our industry, quite frankly, is the fact—or rather, what is resulting in our industry is that you have unemployment costs that you have to pay and your States have to pay.

Senator **Durenberger**. When we did safe harbor leasing, we were trying to help the same kind of people; but we weren't taking it from your competition. We, in effect, were taking it from some ripoff artists who were selling tax benefits—keeping 87 cents on the dollar, and giving 13 cents to the steel company—and we were flioping that around so the steel companies could get the 87 cents.

Mr. **Meagher**. Right. That is right.

Senator **Durenberger**. And the leasing companies, whoever they might be, ended up with 13 cents. I don't see that here. Do you find that much principle in this or some social good in this?

Mr. **Meagher**. Yes. I think that the question that you have to determine is who is going to pay the cost of the loss of American jobs and the loss of American industry. And in this case, the way we view it is that we are in fact as taxpayers subsidizing our own demise.

Senator **Durenberger**. All right. Thank you.

The **Chairman**. Other questions?

Senator **Pryor**. Just one quick one.

The **Chairman**. Senator Pryor.

Senator **Pryor**. Mr. Chairman, a question to Mr. McElwaine. You mentioned how many employees in your group?

Mr. McElwaine. We have 7,500 dealers who employ 200,000 Americans.

Senator Pryor. All right. You mentioned that you sensed there was a feeling there among those individuals that they are willing to pay a greater portion of their income for taxation if it would reduce the deficit? I think that was the message. Now, what type of tax do you think that they would prefer to pay? I mean, do you think they would prefer an increased personal income tax or a sales tax? Or what sort of a tax do you think that they would prefer?

Mr. McElwaine. Senator, nobody likes taxes, but I think the only criteria they would look for would be that it be fair and equitable, that it apply to their competition as well as to them. And all of those kind of broad-bases taxes are, of course, income taxes, not taxes on business expenses, but taxes on earned income. And whether that was a corporate tax or a personal tax, I think, is something that the committee would have to decide.

Senator Pryor. You know, the chairman of this committee has a tremendous obligation and he is in a straitjacket right now. The criterion is a 35-percent maximum individual and corporate tax, revenue neutral, and no new taxes. We are trying to figure this out; and I think we need to reach the point pretty quick if we are going to have some sort of a tax reform bill of 1986.

We are way down in revenues now, but we can't seem to find that secret answer to find where those revenues have got to come from to make up our losses.

Mr. McElwaine. Senator, the efficiency of the system, I think, is of primary importance, too. As I think I demonstrated, this would raise automobie prices by at least $3 billion, of which only about $980 million would accrue to the Treasury. That seems to me to be hopelessly inefficient as a way of raising this needed revenue.

Senator Pryor. I am not saying that I support this excise tax change. I am just saying that I must sympathize with Chairman Packwood in this dilemma.

Mr. McElwaine. I think we all do.

Senator Pryor. And especially after today. I have sat here since 9:30, Mr. Chairman, and I don't know that I have heard anyone—maybe except Secretary Mentz—I think he was for it, and maybe one or two more—I think most of the witnesses have been opposed to it. You are very brave to allow all these witnesses to testify.

The Chairman. I couldn't find anybody for it. [Laughter.]

Senator Pryor. That is all I have, Mr. Chairman.

Senator Matsunaga. I thought Mr. Meagher was for it.

The Chairman. Mr. Meagher is for it.

Senator Matsunaga. Is that the correct spelling of your name?

Mr. Meagher. Yes, sir, it is.

Senator Matsunaga. How do you get "Mahar" out of that? [Laughter.]

Mr. Meagher. Most people pronounce it "Meager," which is an apt description of me. [Laughter.]

But it is an old Irish name that, at some point along the line, was pronounced that way by my family; but I am not sure it is pronounced that way by anybody else.

Senator MATSUNAGA. Well, considering the meaning of the proper pronunciation, I supoose there were numbers of people mispronouncing it. [Laughter.]

One question, Mr. Meagher. Your position is applied only to tariffs and not to excise tax, as I take it?

Mr. MEAGHER. I didn't address myself to the excise tax question.

Senator MATSUNAGA. And you do not intend to? Or do you take the same position?

Mr. MEAGHER. My view of the whole situation is that you would be better served if you went to a business transfer tax, and you wouldn't have to do either of them. It seems to me that the question of leveling the playing field is the point that we are trying to make, and it really needs to be looked at seriously. Both of these provisions—both the tariff and the excise tax provisions—are sort of a halfway step there.

Senator MATSUNAGA. Are you a lawyer by any chance?

Mr. MEAGHER. Pardon me?

Senator MATSUNAGA. Are you an attorney, a lawyer by profession?

Mr. MEAGHER. Yes, I am.

Senator MATSUNAGA. Oh, yes. I understand your language now then. You are saying "Yes." [Laughter.]

The CHAIRMAN. Do you have any other questions?

[No response.]

The CHAIRMAN. Any others? If not, gentlemen, thank you.

We will conclude today with Bob McGlotten, Paul Huard, Robert Dewar, The Honorable Clarence Mitchell III, and John A. Newman.

Bob, why don't you go first? You have been before this committee many times.

STATEMENT OF ROBERT M. McGLOTTEN, DIRECTOR, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, WASHINGTON, DC

Mr. MCGLOTTEN. Thank you very much, Mr. Chairman. I am delighted to be here today to give the views of the AFL-CIO. With me is Arnold Kanner, our chief economist at the AFL-CIO. Mr. Chairman, I have a summary sheet from which I will read, which is one page long; and I ask that my entire statement be entered into the record.

The CHAIRMAN. Without objection. All the statements of the witnesses will be in the record.

Mr. MCGLOTTEN. Thank you very much, Mr. Chairman.

The AFL-CIO is opposed to the proposals for excise tax increases. The attempt to disallow business deductions for Federal excise taxes and tariffs represents a backdoor increase and a regressive form of taxation. The increases in excises on alcohol, tobacco, and fuel straightforwardly add to the repressive taxes. Both measures unfairly affect the living standard and jobs of working people, and neither measure is tax reform.

The excise tax proposal amounts to a major breech of faith with the American peoole. The commitment to tax reform was presented as an effort to provide the revenue needed to lower taxes for most people through measures that would close loopholes. Excise tax increases, rather than loophole-closers, to underwrite income tax cuts amounts to swapping one kind of inequity for another. The proposal violates the concept of business income for tax purposes.

A business could even suffer a loss, yet be required to pay income taxes on its excise tax receipts. Firms and workers employed by these firms would be affected adversely according to the extent to which the excise taxes adds to their productive costs and the ability of the firm to pass the cost on to others. At the current corporate tax rate of 46 percent, the denial of excise tax deduction is equivalent to an 85-percent increase in the excise tax.

If the business cannot or will not absorb the increased tax, there will be an upward pressure on prices and a downward pressure on wages. The manner in which these pressures will be shared will have nothing to do with tax reform. If the excise taxes become higher prices, consumers with lower incomes must spend relatively large portions of their income and will feel the burden most heavily.

The principal Federal excise taxes are on alcohol, beverages, tobacco, gasoline, and diesel fuel, and the use of telephones in airports. The role of such tax as well as the Nation's tariff structure and our revenue system has always been controversial. These levies should be considered on an individual basis. A huge across-the-board increase in excise and tariffs under the guise of tax reform is bad tax policy and certainly questionable as a legislative tactic in a democratic society. The AFL–CIO has consistently supported tax justice. We have always consistently emphasized the need for revenue to offset any tax cut and meet the need for deficit reduction and program support.

We have urged tax reform based on the House-passed act, that would add fairness and raise revenue. Our executive council statement outlining these measures is attached. We urge that you give them serious consideration in your search for fairness and revenue.

And, Mr. Chairman, I will be glad to answer any questions. Thank you.

The CHAIRMAN. Thank you. Mr. Huard.

[The prepared written statement of Mr. McGlotten follows:]

86-13

STATEMENT OF ROBERT McGLOTTEN, DIRECTOR
DEPARTMENT OF LEGISLATION
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS BEFORE THE SENATE COMMITTEE ON FINANCE ON EXCISE TAXES

April 21, 1986

The AFL-CIO is pleased to have this opportunity to present its views in opposition to the proposals for excise tax increases as contained in the March 13, 1986 Finance Committee "Chairman's" proposal.

Under the two-part proposal, an estimated five year total of $63 ($62.6) billion would be raised through disallowing business deductions for federal excise taxes and tariffs, and another $13 ($12.7) billion is anticipated through direct increases in excises on alcohol, tobacco, and fuel. The first part represents a backdoor increase in a regressive form of taxation. And, although it might appear that such a measure would increase business' share of the tax burden, we believe its effect would fall on workers and consumers. The second proposal increases the federal government's use of excises through a front door approach, and is a straightforwardly regressive tax increase.

Both measures would unfairly affect the living standards and jobs of working people and neither measure has any place in a bill that is supposed to represent tax "reform," regardless of perspective or point of view.

Our specific objections are as follows:

1. We believe the excise tax proposal amounts to a major breach of faith with the American people. From the very beginning, the "commitment" to tax reform was presented as an effort to provide the revenue needed to lower taxes for most people through measures that would close loopholes, and lead to a fairer, simpler tax structure. The committee's proposal contains approximately $186 billion in revenue losing, that is tax cutting proposals. The excise tax provisions, however, "pay" for $75 billion or forty percent of the tax reductions. By using excise tax increases, rather than loophole closures, to underwrite income tax cuts, Congress would be doing no more to effect tax reform than to swap one

kind of inequity for another. The widespread opposition to that type of shifting was made quite clear in the recent Citizens For Tax Justice sponsored survey which showed substantial majorities against boosts in excise taxes as a means to pay for the preservation of existing tax inequities.

2. A fundamental source of business tax controversy has been the difficulty of arriving at an appropriate and consistent definition of net income for tax purposes. Defining costs and therefore net income for tax purposes is, for example, the basis of the complexities which surround the accounting for depreciation. The excise tax proposal completely violates the concept of business income for tax purposes. In fact, as we understand the proposal, a business could even suffer a net loss yet still be required to pay income taxes on its excise tax receipts. Since a legitimate cost of doing business would no longer be allowed as a deduction, the income tax burden of a particular firm or industry would vary according to the imperatives of its production process. Such a tax fails a basic test of tax policy: the goal of treating equals equally. Firms and workers employed by those firms would be affected adversely according to the extent and degree to which the items subject to excise tax figure in their production process, and the ability of the firm to pass the costs on to others.

At the current corporate tax rate of 46%, the denial of the excise tax deduction is equivalent to an 85% increase in the excise tax. That is, since a dollar of excise tax paid would be considered a dollar of income, the firm would have to increase its total receipts by $1.85 just in order to avoid an increase in costs and/or a reduction in profits. In other words, for a firm to be able to pay the dollar to the federal government as an excise tax, the firm would need $1.85, ($1.85 less 46% tax would equal $1.00). At the proposed corporate rate of 35%, the effective excise tax increase amounts to 54%.

3. If the business cannot, or will not, absorb the increased tax burden, there will be **upward pressure on prices and downward pressure on wages**. As important, the manner in which these pressures will be shared will have nothing to do with the goals of a good tax structure or an equitable tax reform package.

If the excise taxes paid on items that enter into a business' costs of production become higher prices for consumers, they are unfair for two reasons. First, people with low incomes must spend a relatively larger proportion of their income, and therefore the burden falls more heavily on those who can least afford it. Second, taxes that so selectively affect business costs create unfair competitive situations by discriminating against the firms, industries, and their workers that happen to utilize taxed commodities or services.

On the other side of that same coin are the distortions that result, which make the tax structure a larger factor in business decision-making and increase tax shelter activities. Again, these are results that are contrary to the goals of tax reform.

4. Federal excise taxes for the most part contain an element of support as either "sin" taxes, and as "user" fees, in that they accord with the notion of those who feel that there should be a close indentity between those paying the tax and those who benefit directly from the good or service. The principle federal excise taxes are on alcoholic beverages, tobacco, gasoline and diesel fuel, and the use of telephones and airports. The role of such taxes in our revenue system has always been a subject of substantial controversy and, of course, the nation's tariff structure and its role is a subject that this committee has confronted on numerous occasions.

We have some rather strong feelings on many of these issues, but at the same time we feel that these levies should be considered on an individual basis, and on their own merits. A huge across the board increase in excises and tariffs under the guise of tax reform is clearly bad tax policy and certainly questionable as a legislative tactic in a democratic society.

The AFL-CIO has consistently supported tax justice efforts. We have also, from the opening round of the current tax debate, emphasized the need for revenue to offset any tax cuts, as well as the need for deficit reduction and program support. Most recently, we have urged enactment of a tax reform package based on the House-passed Tax Reform Act that would add fairness to the tax code as well as raise revenue. The AFL-CIO Executive Council statement of last February outlining those measures is attached. We urge that you give them serious consideration in your search for tax fairness and tax revenue.

Thank you.

Statement by the AFL-CIO Executive Council

on

Tax Policy

February 18, 1986
Bal Harbour, FL

A bizarre drama is unfolding in Washington.

President Reagan threatens to veto any tax increase while calling for major weakening of the progressive features of the House-passed tax bill and massive increases in defense spending.

Senate tax writers are seeking new sources of revenue to offset losses expected if they give back to corporations and wealthy individuals tax breaks that were taken away in the House bill.

At the same time, both House and Senate budget writers are seeking new revenues to lessen the harsh consequences of the Gramm-Rudman-Hollings deficit reduction scheme. All parties declare each other's proposals "dead on arrival."

The AFL-CIO urges the Congress to resolve this stalemate by adopting the constructive provisions of the House-passed Tax Reform Act of 1985 (H.R. 3838) and to build upon that revenue-neutral bill by raising additional revenues to meet the nation's needs and combat the federal budget deficits. This can be accomplished without taxing middle-class protections such as employer-provided benefits and without eliminating the deduction for state and local taxes. Nor is there any justification for creating new inequities through the enactment of value-added taxes, selective excise or consumption taxes which bear most heavily on low-and middle-income working families.

The House-passed tax bill contains many provisions long advocated by the AFL-CIO to curb loopholes and limit the special privileges of the wealthy and the corporations. Taxes are lowered for many who have been paying more than their fair share, and 6.5 million poverty-stricken Americans would be removed from the rolls.

The House bill explicitly rejects many of the Administration's proposals which would have hurt workers and the communities in which they live. However, unduly harsh provisions affecting public employees, unemployment compensation recipients and workers with job related income averaging problems remain in the bill and must be rectified in the Senate.

We are particularly pleased that the House of Representatives repudiated the Administration's attempt to levy a tax on working people's health care, life insurance, death benefits, legal services, education and disability compensation; and chose to retain the existing deduction for state and local taxes, thereby protecting the citizens of those localities which have assumed the responsibility for high-quality education and other public programs.

We believe that the needed additional revenues can be raised without harm to middle- and low-income taxpayers. Congress, in completing action on the tax bill, should:

- establish a 45 percent fourth tax bracket;
- curb the reduction in the corporate tax rate;
- reduce the preferential treatment for capital gains;
- curb privileges of the oil and gas industry;
- transform the foreign tax credit to a deduction and limit deferrability;
- curb tax shelters;
- raise the individual and corporate minimum tax;
- reject the proposal for a 10 percent corporate deduction for dividends paid.

By taking these steps, the Congress could raise $41.5 billion in the first year after enactment and more than $200 billion over the first five years while taking major strides toward true tax reform and fiscal responsibility.

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Fact Sheet

Fact Sheet

on

Tax Policy

The details of the AFL-CIO proposed tax changes:

1. Raise the fourth bracket from 38 percent to 45 percent for those individuals with $100,000 in income filing joint returns. Such a move could raise $4.3 billion in the first year after enactment.

2. Curb the reduction in the corporate tax rate to 41 percent instead of the 36 percent contained in H.R. 3838. This would raise $12.5 billion in the first year.

3. Reduce the preferential treatment for capital gains. By reducing the exclusion for capital gains from 42 percent (contained in H.R. 3838) to 40 percent combined with the proposal for an individual rate of 45 percent, the Congress could raise an additional $4.1 billion in the first year.

4. Curb the privileges of the oil and gas industry. H.R. 3838 contains only a portion of the reforms proposed in the original Treasury plan. Returning to that proposal would raise $6.2 billion in first year revenues.

5. Transform the foreign tax credit to a deduction. The existence of the foreign tax credit combined with the deferral privilege encourages U.S. firms to invest, produce and create jobs overseas. By building on the provisions of H.R. 3838, the Congress would raise $9.7 billion in first year revenues.

6. Impose a minimum tax of 25 percent on all corporate income over $150,000 and all individual income over $100,000. This provision would raise $4.2 billion over the House-passed bill.

7. Curb tax shelters. By adopting the Treasury I proposal to tax large partnerships, as the corporations that they are in all but name, the Congress could raise $300 million in the first year after passage.

8. Reject the proposal for a 10 percent corporate deduction for dividends paid. This provision would cost the Treasury $200 million per year for something that corporations would do in any event: distribute dividends to their shareholders.

###

Total Revenue: $41.5 billion

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. HUARD. Thank you, Mr. Chairman. I am pleased to be here to present the NAM's testimony opposing the proposed denial of deductibility of excise taxes and tariffs paid in the ordinary course of business.

First, let me emphasize that our adamant opposition to this proposal is not based on the fact that, though nominally designed as an income tax increase, it would in effect operate as a tax increase on consumption. In general, NAM is supportive of changes in Federal tax policy that would reverse the existing bias of our tax system which greatly favors consumption at the expense of savings and investment.

Viewing the proposal at hand as a consumption tax, however, we find it to be deficient in several significant respects. Perhaps the most objectionable feature is that it would have disproportionate impacts on narrow, selected sectors of the economy. In our view, any tax on consumption should be applied to the broadest possible base of both goods and services so as to spread its burden equitably across the entire economy. In this context, omission of services from a consumption-type tax would be unfair to those groups such as lower income individuals that tend to consume more goods than services.

Another problem with this proposal is that, while it might have the effect of being a tax on consumption, such tax will not be visible to the consumer since it will be passed forward through increases in the price of affected items.

NAM believes that any tax on consumption should be separately stated or invoiced and thus be readily identifiable so that taxpayers may be fully informed of what they are paying to support the operations of Government.

Turning now to my second point, we believe nondeductibility of excise taxes is fundamentally inconsistent with the traditional concept of the Federal income tax as a tax on net income. Unfortunately this is not the only manifestation of such an inconsistency to surface during the so-called reform effort. It is also evident in the proposals to deny deductions for part of the cost of business meals and entertainment. Presumably, it was at least part of the underlying rationale for the widely rumored proposals which ultimately were not included in the option drafted by the committee staff to deny deductibility for part of the costs incurred by a business taxpayer for items such as debt service and advertising.

The proposal to deny excise tax deductibility for business income tax purposes is particularly pernicious in that it apparently would require payment of a 35-percent tax on the full amount of excise taxes paid or, for that matter, merely collected and remitted in the ordinary course of business, even though the taxpayer otherwise has no net income from such business. As such, it may be correctly viewed as either a tax on a tax or a tax on gross receipts, but most assuredly not as a tax on income.

There is a constitutional question involved here, and it is a serious one. The 16th amendment to the U.S. Constitution was added to prevent Congress from levying income taxes that were not apportioned. If, however, denying business expense deductions for excise taxes paid is really, as suggested, a gross receipts tax and not an income tax, it may be constitutionally invalid.

My final point is that we probably would not even be considering the issue of excise tax deductibility today were it not for the perceived need to raise tens of billions in new revenues to finance politically attractive, but in other respects, unwarranted tax cuts for individuals. The plain truth is that individuals are not demonstratably overtaxed relative to corporations. Indeed, as a proportion of their income, corporations pay Federal tax at an average effective rate that is at least twice that of individuals.

It is politics and not economics that has driven the steady parade over the past 18 months of so-called reform proposals whose basic thrust, when all is said and done, is to transfer something like $25 to $35 billion annually from corporations to individuals. That, however, gets us somewhat beyond the scope of these hearings. I will be glad to address any questions the committee may have.

The **CHAIRMAN**. Thank you. Mr. Huard.

Mr. **DEWAR**. That was me, Senator.

The **CHAIRMAN**. Oh, excuse me. Mr. Dewar.

[The prepared written statement of Mr. Huard follows:]

Statement of

The National Association of Manufacturers

on

The Tax Treatment of Federal Excise Taxes

Before the

Senate Committee on Finance

Monday, April 21, 1986

Presented By:

Paul R. Huard
Vice President, Taxation and Fiscal Policy
National Association of Manufacturers

Mr. Chairman, I am Paul R. Huard, Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers. NAM is a voluntary business association of about 13,500 member companies, large and small, located in every state. Our members range in size from the very large to over 9,000 small manufacturing firms that each have less than 500 employees. NAM member companies employ 85% of all workers in manufacturing and produce over 80% of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here to express NAM's views on the proposal to repeal the business expense deductibility, for income tax purposes, of federal excise taxes. We believe such proposal to be both economically and legally unsound and urge that it be dropped entirely. Our major objections are as follows:

1. Nondeductibility of excise taxes would, in effect, prove to be little more than a thinly-disguised tax on consumption. The burden of this tax would fall, both arbitrarily and quite heavily, on a few narrow sectors of the economy. NAM supports a shift in the emphasis of federal tax policy more towards taxation of consumption and less towards taxation of income from work, savings and investment, all of which at present are taxed excessively. We believe, however, that a properly-designed consumption tax must be both broadly-based and visible.

2. As applied to business taxpayers, the federal income tax traditionally has been viewed as a tax on net income, i.e., gross income less the costs incurred in generating such income. Arbitrarily denying expense deductions for excise taxes paid in the ordinary course of business would erode this traditional concept, and result in a partial conversion of the federal income tax into a federal gross receipts tax. This would be highly undesirable from a policy standpoint and, in addition, raises serious constitutional questions since the Sixteenth Amendment authorizes an income tax, not a gross receipts tax.

3. The stated justification for this proposal is to raise enough revenue to make possible passage a "reform" bill that, bluntly characterized, would cause a massive redistribution of income tax liabilities from individuals to corporations. Such a result cannot be justified on the grounds of fairness, since corporations are not demonstrably undertaxed relative to individuals. Nor will it help improve the international competitiveness of U.S.-based manufacturers.

In the balance of this testimony, I would like to amplify somewhat the points summarized above.

First, let me emphasize again that our adamant opposition to this proposal is *not* based on the fact that, thought nominally designed as an income tax increase, it would in effect operate as a tax increase on consumption. In general, NAM would be supportive of changes in federal tax policy that would reverse the existing bias of our tax system favoring consumption at the expense of savings and investment. In this connection, our Board of Directors in 1984 adopted a policy position on the general topic of consumption taxation. The full text of that position is included as an Appendix hereto. Among other things, it enumerates various principles which should be followed in designing any consumption-based tax.

In applying these principles to the proposal at hand, we find it to be deficient in several respects. Perhaps the most objectionable feature is that it would have a disproportionate impact on narrow, selected sectors of the economy. In our view, any tax on consumption should be applied to the broadest possible base of both goods *and* services, so as to spread its burden equitably across the entire economy. In this context, omission of services from the base of a consumption tax would be unfair to those groups [*e.g.*, lower income individuals] that tend to consume more goods than services.

Another problem with this proposal is that, while it might have the effect of being a tax on consumption, such tax will not be visible to the consumer since it will be passed forward through increases in the price of affected items. NAM believes that any tax on consumption should be separately stated and readily identifiable, so that taxpayers may be fully informed of what they are paying to support the operations of the government.

Turning now to my second point, we believe nondeductibility of excise taxes is fundamentally inconsistent with the traditional concept of the federal income tax as a tax on net income. Unfortunately, this is not the only manifestation of such inconsistency to surface during the "reform" effort. It is also evident in the proposals to deny deductions for part of the cost of business meals and entertainment. Presumably, it was at least part of the underlying rationale for the widely rumored proposals--which ultimately were not included in the option drafted by the Finance Committee staff--to deny deductibility for part of the costs incurred by a business taxpayer for items such as debt service and advertising.

The proposal to deny excise tax deductibility for business income tax purposes is particularly pernicious in that it apparently would require payment of 35% tax on the full amount of excise taxes paid [or, for that matter, merely collected and remitted] in the ordinary course of business even though the taxpayer otherwise has no net income from such business! As such, it may be correctly viewed as either a tax on a tax, or as a tax on gross receipts, but most assuredly not as a tax on income.

There is a constitutional question involved here and it is a serious one. The Sixteenth Amendment to the U.S. Constitution was added to permit Congress to levy income taxes that were not apportioned. If, however, denying business expense deductions for excise taxes paid is really, as suggested, a gross receipts tax and not an income tax, it may be constitutionally invalid. Given the amounts of revenue involved, this change should not be adopted until a great deal more thought has been given to the issue of its potential unconstitutionality.

My final point is that we probably would not even be considering the issue of excise tax deductibility today were it not for the perceived need to raise tens of billions in new revenues to finance politically attractive but in other respects unwarranted tax cuts for individuals. The plain truth is that individuals are not demonstrably overtaxed relative to corporations. Indeed, as a proportion of their income, corporations pay federal income taxes at an average effective rate that is at least twice that of individuals.

It is politics, not economics, that has driven the steady parade, over the past 18 months, of "reform" proposals whose basic thrust, when all is said and done, is to transfer something like $25 billion to $35 billion annually from corporations to individuals. These shifts would in no way serve the original goals of the reform effort: fairness, simplicity and economic growth. They are not required by fairness, since corporations already pay a higher proportion of their income in federal taxes than individuals. Simplicity to all intents and purposes disappeared from the reform process long ago. And the consensus of most macroeconomic analysis is negative on the questions of how this type of "reform" will affect productivity, business investment and international competitiveness.

NAM's position, which we took with respect to the House version of tax "reform" (H.R. 3838), and which applies with equal force to the bill under consideration here, is that Congress should set aside consideration of major tax changes in favor of dealing with the more pressing problems cause by our twin deficits: budget and trade. That, however, gets us somewhat beyond the scope of these hearings.

I would be pleased at this point to address any specific questions the Chairman or members of the Committee may have on the excise tax deductibility issue.

Thank you.

Consumption Taxation

The key to lowering deficits must be reductions in the growth of federal spending across the board. If, however, Congress decides to increase federal tax revenues as part of a deficit reduction program including comparable or greater reductions in the growth of federal expenditures, such an increase should be accomplished through a consumption-based tax.

Attempts to increase income tax revenues through a multitude of patchwork changes, as has been the practice in the past, will only further complicate a tax system which already is excessively complex; moreover, such changes can only lead to further erosion of the important capital formation incentives that are available under present law. A massive overhaul of the existing income tax structure—by greatly expanding the tax base through broadened definitions of income and extensive repeal of existing deductions and credits—is likely to exacerbate the existing bias in our tax system favoring consumption at the expense of savings and investment.

A consumption-based tax should be designed in accordance with the following principles:

1. It should apply on a transaction basis, *e.g.*, it should be imposed on an *ad valorem* basis when a taxable product or service changes hands. Indirect taxation of consumption, for instance by a "consumed income" type of tax that provides unlimited deductions for net savings and investment, is theoretically attractive and meets a desirable goal: the stimulation of increased capital formation. For the present, however, such an approach is impractical due to the many definitional, transitional and political problems it would raise.

2. It should apply to the broadest possible base of taxable goods and services, so as to spread its burden equitably across the entire economy, while at the same time permitting the tax rate to be as low as possible given the amount of revenue intended to be raised. Omission of the service sector from the tax base would be unfair, requiring higher rates on a narrower base and impacting more heavily on those groups that consume more goods than services.

3. It should apply to the full value of covered goods and services, up to and including retail value, and should be separately stated and readily identifiable. Transaction-based tax systems that omit the retail level will necessarily result in an undesirable narrowing of the tax base.

4. It should include appropriate adjustments to mitigate its impact on low income individuals.

5. If it is paid at multiple points in the distribution process, appropriate credits for such prior payments must be allowed to prevent the pyramiding of taxes upon taxes.

Revenues from a transaction-based consumption tax should be used in part to replace revenues from the existing federal taxes, thus reducing the government's excessive reliance on the taxation of individual and corporate income, permitting general lowering of income tax rates and facilitating the process of tax reform and simplification. Revenues not so used should be dedicated solely to deficit reduction.

10-4-85.

STATEMENT OF ROBERT E. DEWAR, CHAIRMAN, EXECUTIVE AND FINANCE COMMITTEES, K MART CORP., TROY, MI, ON BEHALF OF THE NATIONAL RETAIL MERCHANTS ASSOCIATION

Mr. DEWAR. Thank you, Mr. Chairman. I am Robert E. Dewar, chairman of the Executive and Finance Committee of the K mart Corp. I am testifying today on behalf of the National Retail Merchants Association. As you are aware, the retailing industry in general and K mart Corp. in particular have been strong proponents of tax reform efforts that will reduce both corporate and individual income tax rates. Our industry has historically paid Federal income taxes at high effective rates.

Since fundamental tax reform efforts began in late 1984, we have supported these efforts in the belief that lower tax rates and a broadened tax base would reduce disparities in income tax burdens among various industries. However, we are very disappointed and wish to express our opposition to the provision that would deny corporate income tax deductions for all customs, tariffs, and excise taxes.

This proposal unfairly penalizes retailers in particular who import goods from foreign producers. For example, K mart Corp. imports approximately 15 percent of the products that are sold in our stores. Retailers import products in order to provide the lowest cost goods at the best value for our customers. Tariffs significantly increase our costs of merchandise sold. In particular, those retailers who sell a large number of textile and apparel items are severely impacted as the tariffs on these particular types of goods average 22 percent, which is four times the average of all other tariffs.

If tariffs and excise taxes on goods and services purchased in the ordinary course of business are not deductible, the tax burden will be partially or totally passed on to consumers. Any passthrough would make our tax system more regressive by discriminating against low- and middle-income consumers. According to the recently issued deSeve report, the effect of tariff and excise tax increases would offset 45 percent of all individual income tax reductions in 1988 under the Senate Finance Committee's draft proposal with the lower income taxpayers hit the hardest. Absent the existing tax proposals, the draft bill would reduce the taxes on family incomes under $10,000 by 77 percent; but if the excise bill were enacted, the reduction would be limited to 13 percent, a lesser reduction than families with a higher income.

While the nondeductibility of tariffs and excise taxes is being touted as a major revenue-raising provision, enactment of this proposal could reduce corporate income tax revenues. To the extent that the increased effective costs of products purchased that are subject to tariffs and excise taxes could not be passed on to consumers, they would increase the cost of goods sold by businesses. Increasing this cost reduces the net income of businesses that are subject to corporate income tax. Therefore, the projected revenues to be raised from this proposal may be substantially less than projected.

Denying the deduction for customs tariffs and excise taxes, could lessen the ability of the U.S. businesses to compete in the world market. The U.S. deplores any action by foreign nations, which discriminates against export of products from the United States. The nondeductibility of customs tariffs would negate recent progress in eliminating trade barriers, and could lead to retaliation by our trading partners. At a time when the United States is attempting to promote gains, in export business to improve the balance of trade, the nondeductibility provision in the present tax proposal is not well timed. To remove the income tax deductibility of customs duties at this time, would severely cloud the states of imported materials and merchandise, which provide consumers with genuine price economies, whether the imports are finished industrial products, consumer products, raw materials, parts, or any other products. The proposal to disallow the deductibility of tariffs and excise taxes, creates a major tax redistribution system under which retailers will pay additional taxes, to provide lower tax rates for others.

Instead of closing loopholes, and eliminating tax preferences to make up revenue shortfalls, the proposal would impose a substantial tax increase, on selected businesses, simply because they happen to be subject to tariffs, or Federal excise taxes. The maximum corporate income tax rate of 35 percent for corporations, and individuals, promised by this tax reform package, would be denied to an important segment of the business community.

By increasing the tax burdens upon those businesses which are already paying a disproportionate share, the proposal exacerbates the inequities in our tax system. I urge you gentlemen to carefully consider the adverse impact, that the nondeductibility of Federal tariffs, and excise taxes, would have both on the retailing industry and the U.S. consumer.

I thank you for the opportunity to appear before you.

The CHAIRMAN. Thank you. Did Mr. Mitchell arrive?

[No response.]

The CHAIRMAN. If not, Mr. Newman, go right ahead.

[The prepared written statement of Mr. Dewar follows:]

National Retail Merchants Association
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75th Anniversary
1911-1986

STATEMENT OF

ROBERT E. DEWAR

CHAIRMAN OF THE EXECUTIVE AND FINANCE COMMITTEES

K MART CORPORATION

ON BEHALF OF THE

NATIONAL RETAIL MERCHANTS ASSOCIATION

BEFORE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON THE

TARIFFS AND EXCISE TAXES PROVISIONS OF

SENATOR PACKWOOD'S TAX

REFORM PROPOSALS

APRIL 21, 1986

EXECUTIVE OFFICERS

Chairman of the Board
SUMNER FELDBERG
Chairman of the Board
Zayre Corp
Framingham, Massachusetts

First Vice Chairman of the Board
EDWARD S. FINKELSTEIN
Chairman and Chief Executive Officer
R H Macy & Co., Inc
New York, New York

Second Vice Chairman of the Board
HOWARD GOLDFEDER
Chairman and Chief Executive Officer
Federated Department Stores, Inc
Cincinnati, Ohio

President
JAMES R. WILLIAMS
NRMA
100 West 31st Street
New York, New York

Home Office 100 West 31st Street, New York, N Y 10001

Thank you Mr. Chairman. I am Robert E. Dewar, Chairman of the Executive and Finance Committees of K mart Corporation. K mart Corporation operates over 2,400 general merchandise and specialty stores in the United States, Canada and Puerto Rico, with sales of over $22.4 billion in 1985. I am testifying today on behalf of the National Retail Merchants Association. NRMA is the nation's largest trade association for the general merchandise retail industry. Its members operate 45,000 department, chain, independent and specialty stores in all 50 states. Their annual sales exceed $150 billion and they employ more than three million workers. The vast majority of NRMA's members are small, independent retailers with annual sales of less than $1 million. This statement is also endorsed by the American Retail Federation, the Association of General Merchandise Chains and the Retail Industry Trade Action Coalition.

As you are aware, the retailing industry in general, and K mart Corporation in particular, have been strong proponents of tax reform efforts that will reduce both corporate and individual income tax rates. Our industry has historically paid federal income taxes at high effective rates. Since fundamental tax reform efforts began in late 1984, we have continuously supported these efforts in large measure because of our belief that lower tax rates and a broadened tax base would reduce disparities in income tax burdens among various industries.

However, we are extremely disappointed and wish to express our opposition to the provision that would deny corporate income tax deductions for all customs tariffs and excise taxes. Not allowing the deduction for tariffs and excise taxes unfairly penalizes those businesses that are required to pay these amounts as part of the overall cost of acquiring goods. This proposal unfairly penalizes retailers in particular who import goods from foreign producers. For example, K mart Corporation imports approximately 15% of the products that are sold in our stores. Retailers import products in order to provide the lowest cost goods at the best value for our customers. Tariffs significantly increase our cost of merchandise sold. In particular, those retailers who sell a large number of textile and apparel items are severely impacted, as the tariffs on these particular types of goods average 22%, which is over four times the average of all other tariffs. In addition, tariffs on textile and apparel items accounted for approximately 26% of total duties of $13 billion collected by the federal government during 1985.

Denying a deduction for tariffs and excise taxes does not further the tax reform goals of simplification and base broadening. Tariffs and excise taxes are levied on a wide variety of goods and services necessary for the everyday operation of all businesses. Denying deduction of these normal costs of doing business unfairly burdens those businesses which, because of their nature, are either forced to import certain products, or purchase services subject to excise taxes.

Denying the deduction for tariffs and excise taxes alters the nature and basis of the corporate income tax. The corporate income tax is a tax on net income, and not gross income. Existing tax law allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business. If these deductions were not allowed, the corporate income tax would be more equivalent to a sales tax rather than an income tax. Under the income tax concept, federal tariffs and excise taxes are currently deductible as a cost of doing business. In contrast with other expenses, businesses have no control over the tariff or excise tax cost imposed on them. No matter how efficient a business may be in reducing other costs of operation, it still is saddled with paying tariffs and excise taxes as part of its cost of doing business. Therefore, denying the deduction for tariffs and excise taxes unfairly penalizes business, as these costs cannot be reduced or eliminated by the business entity.

Elimination of the deductibility for tariffs and excise taxes is especially burdensome for the retail community which already bears a high effective tax burden. The current corporate tax system is full of inequities. Under existing tax law, many capital-intensive industries are able to take advantage of certain tax deductions which drastically reduce their effective tax rates. On the other hand, most labor intensive industries such as retailing have few deductions available to them, and pay high effective tax rates.

The denial of deductibility of tariffs and excise taxes would only widen this disparity among differing industries. In fact, denying the deduction for tariffs and excise taxes is an indirect way of actually increasing these taxes. The current deductibility of tariffs and excise taxes against a 46 percent corporate tax rate results in a "net tariff" of 54 percent. Moreover, a deduction against the 35 percent corporate tax rate proposed by the Chairman would provide a "net tariff" of 65 percent, which is a 20 percent increase. Furthermore, totally denying the deduction would raise the "net tariff" cost to 100 percent. This results in a considerable tax increase, particularly for the retailing industry which already has a high effective tax rate.

If the tariff and excise taxes on goods and services purchased in the ordinary course of business are not deductible, the tax burden will be either partially or totally passed on to consumers. Any pass-through would make our tax system more regressive by discriminating against low- and middle-income consumers. According to the recently issued deSeve Report, the effective tariff and excise tax increases would offset 45 percent of all individual income tax reductions in 1988 under the Senate Finance Committee's draft proposal, with the lower income tax payers hit the hardest. (Mr. Chairman, I would be glad to supply a copy of this report for the record, if you wish.)

While the non-deductibility of tariffs and excise taxes is being touted as a major revenue raising provision, enactment of this proposal could reduce corporate income tax revenues. To the extent the increased effective costs of products purchased that are subject to tariffs and excise taxes could not be passed on to consumers, they would increase the costs of goods sold by business. Increasing this cost reduces the net income of business that is subject to the corporate income tax. Therefore, the projected revenues to be raised from this proposal may be substantially less than projected.

Denying the deduction for customs tariffs could lessen the ability of U.S. businesses to compete in the world-wide market. The U.S. deplores any action taken by foreign nations which discriminates against exported goods from the U.S. The non-deductibility of customs tariffs would negate recent progress in eliminating trade barriers, and could potentially lead to retaliation by our trading partners. At a time when the United States is attempting to encourage and promote gains in export business to improve the balance of trade, to expand markets, and to earn foreign exchange favor, the non-deductibility provision in the present tax proposal is not well-timed. Indeed, the resultant reduction of price competitiveness of U.S. exports containing imported elements is a trade dampening policy which the U.S. should not be pursuing. To remove the income tax deductibility of customs duties at this time would severely cloud the status of imported materials and merchandise which provide consumers with genuine price economies, whether the imports are finished industrial products, consumer products, raw materials , parts, or any other products.

The retailing community has been actively involved in the development of an overall tax reform package that will achieve the important objectives of reducing tax disparities among industries, and reducing the effective burden for individuals. The proposal to disallow the deductibility of tariffs and excise taxes creates a major tax redistribution system under which retailers will pay additional income taxes merely to provide lower tax rates for others. Instead of closing loopholes, and eliminating tax preferences to make up revenue shortfalls, the proposal would impose a substantial tax increase on selected businesses simply because they happen to be subject to tariffs or federal excise taxes. The maximum corporate income tax rate of 35 percent for corporations and individuals promised by this tax reform package would be denied to an important segment of the business community. By increasing the tax burdens upon those businesses which are already paying a disproportionate share, the proposal exacerbates the inequities in our tax system.

I urge you to carefully consider the adverse impact that non-deductibility of federal tariffs and excise taxes would have on both the retailing industry and the U.S. consumer.

I thank you for the opportunity to appear before you today.

STATEMENT OF JOHN A. NEWMAN, TAX ATTORNEY, PITTSBURGH, PA

Mr. NEWMAN. Mr. Chairman, members of the committee, my name is John Newman. I am a tax attorney in private practice. I come here today as an individual without any extraneous ties to any group or organization.

The committee has just endured an onslaught of criticism in its search for an alternative source of revenue to implement major tax reform, which is not regressive and which does not run roughshod over any particular industry group.

Needless to say, this is a devisive issue, and I would hate to see tax reform depend on it. I would like to help in this important effort with a proposal which is the culmination of a 3-year effort, to create an alternative source of revenue with the very purpose of meeting this committee's immediate goal of implementing major tax reform, for the more long term goal of laying the groundwork for substantial deficit reduction, and to provide a new tool in the important effort to coordinate fiscal and monetary policy.

The proposal—what I call a Federal par user's fee—would be a comprehensive, low-rate user's fee imposed on the transfer of funds through the U.S. payments mechanism. It would compensate the Government for its central role in providing, and maintaining efficient, and secure payment channels to all economic participants.

Now, by U.S. payments mechanism, I use that term rather loosely, to include any payment channeled through an automated clearance system supportedby automated record-keeping machinery. It would include any payment by check, electronic transfer through automatic teller machine, or point of sale terminals, which are now appearing in retail establishments.

It would include any transfer over the Federal Reserve wire system, BankWire, CHIPS, and any private clearing house. It would also include the local clearing of checks and drafts, and other payments representing about 25 percent of the checks drawn in the country, and any other system which might be developed in the future. Thus, defined comprehensively, the revenue base would be approximately $220 trillion per year; and on a revenue base that is that large, it would be possible to raise a considerable amount of revenue through a very small, almost negligible fee, at the rate of 1/100th of 1 percent, that is 0.0001 or, commonly referred to as one "basis point."

On a tax base of $220 trillion, it would be possible to raise over $20 billion a year, meeting this committee's immediate need for approximately $100 billion over 5 years. At a rate of 1/20th of 1 percent, or five basis points, it would be possible to raise $110 billion per year, enough to launch a direct assault on the Federal budget deficit.

Let me just back up for a second, if I could, and just give an idea of the magnitude of that fee. For example, on a $100 payment for groceries, the fee would be 1 cent. On a $1,000 paycheck or mortgage payment, the fee would be 10 cents. On the purchase of a $10,000 automobile, the fee would be $1. On an outright purchase of a $100,000 personal residence, the fee would be $10. On a $1 million equipment purchase, $100; and on a $10 million capital improvement, $1,000. Now, that is at the rate of one basis point.

And on the institutional side, although that might at first appear to be more than a negligible fee, I think it is worth pointing out that one basis point, is the amount that you could earn by investing that money for an afternoon.

Finally, with statutory authority delegated to either the Federal Reserve or the U.S. Treasury, it would be possible to have them monitor and adjust what I call the par rate, periodically across a narrow predetermined range, if economic circumstances require. And as a consequence, this proposal could provide an entirely new tool in the effort to coordinate fiscal and monetary policy.

Now, with the remaining time that I have, I would like to point out that, unlike the excise tax provisions, this par user's fee would be progressive in operation. It would help to stabilize the economy, providing a predictable source of revenues. I believe it would be about the most simple user fee imaginable, so it would comply with the goal of simplicity in tax reform.

Like I said, it would help this committee in its important effort to implement major tax reform to provide an overall benefit to the economy. Thank you.

[The prepared written statement of Mr. Newman follows:]

John A. Newman
Senate Committee on
Finance
April 21, 1986

A FEDERAL 'PAR' USER'S FEE TO CUT THE DEFICIT AND FACILITATE TAX REFORM

I. Introduction

The national debt, now approaching $2 trillion, is seriously jeopardizing the United States' prospects for a successful transition into the next century. Central to the country's effort at deficit reduction will be the 99th Congress's resourcefulness and commitment to cut spending and to restructure our federal tax system, which is now considered to be in disarray. Recent studies suggest, however, that even with all feasible cuts in defense and nondefense spending, annual deficits of at least $100 billion will remain. With Commerce Department estimates showing erratic and unpredictable GNP growth, it would be improvident to expect economic growth to yield the required additional revenues.

The Senate is now engaged in a difficult effort to restructure our present tax system into a modified "flat rate" income tax whereby numerous tax preferences encumbering the present system would be eliminated in exchange for lower marginal tax rates. In accordance with President Reagan's and the Senate leadership's directive not to raise taxes, these efforts, while addressing the urgent need for fundamental tax reform, are not designed to raise any more revenue than the present system. For these and other reasons, Congress and the Administration have rejected proposals for a value-added tax or national sales tax to combat the deficit.

In light of the clear need for deficit reduction and tax reform, and the defects in existing alternatives, Congress must be resourceful in developing new sources of revenue extraneous to the present tax system. Significantly, the Administration recently confirmed that while it opposes any tax increase, it has no objection to the imposition of new "user fees" to compensate for the use of governmental services. If so, then one alternative that should be considered is a comprehensive, low rate clearance fee imposed on checks and other payments as they move through the bank clearance process. Similar in operation to exchange fees imposed by institutions engaged in "non-par" banking at the turn of the century, a modern federal "par" fee on checks, drafts, and electronic payments would compensate the government for its central role in maintaining efficient and secure payment channels and its broader efforts to promote stability of financial markets, a benefit to all economic participants. Such a user's fee would penetrate deeply into the fabric of the everyday economy, co-exist with the lowest possible profile and, most importantly, raise considerable amounts of revenue. Presently, over 90 percent of all payments in this country - approximately $220 trillion - pass through existing non-cash payment mechanisms each year. At an effective rate of one-twentieth of one percent (i.e. five basis points, the functional equivalent of less than two days' investment "float"), a "par" fee could raise $110 billion in revenue; enough to help balance the budget and facilitate the difficult transition to a modified flat rate income tax system. The following discussion reviews the existing United States payments mechanism, the immediate potential for a par fee system, and (although in the nature of a user's fee rather than a tax), the discussion finishes with a tax policy analysis of the par fee proposal.

II. Overview of the United States Payments Mechanism

The United States payments mechanism facilitates the transfer of funds among participants in the economy. Nearly all such payments are made through one of the following channels: 1) cash; 2) paper checks drawn on credit or demand deposits; 3) electronic "checks" drawn on credit or demand deposits; and 4) wire transfers. Total annual non-cash payments in this country approximate $220 trillion, all of which are being channeled through highly automated processing machinery now in existence.

A. Currency and Coin

There is approximately $175 billion of currency and coin currently in circulation in the United States, over one-half of which is comprised of $50 and $100 bills. Aside from legitimate purposes, the use of cash is central to the underground economy, which is now estimated to exceed $220 billion. Although cash payments represent by far the largest number of money transactions, in terms of total dollar value cash payments constitute less than 10 percent of the total money transactions.

B. Paper Checks

Paper checks were developed as an alternative to cash transactions and have occupied a major position in the United States payments mechanism since 1865. By 1979, approximately 35 billion checks were being drawn annually for over $20 trillion, with an average amount per check of $570. Prior to the enactment of the Federal Reserve Act, checks not cleared locally were cleared through a system of private clearinghouses. Acting as intermediaries, clearinghouses provided efficiencies through net settlement between pairs of banks. In the case of out-of-town checks, however, banks developed the practice of levying an exchange fee of one-fourth of one percent of the face amount of the check for clearance services, a practice known as "nonpar" banking. To avoid out-of-town status, and thus the exchange fees, banks engaged in circuitous routing of checks, thereby producing inefficiency and delay in the clearance process. Nonpar banking constituted an impediment to efficiency. Partly in response to the need for greater uniformity and efficiency in the check clearance process, Congress created the Federal Reserve System in 1913. Federal Reserve Banks offered centralized and efficient processing of checks, but only on the condition that participating banks abandon the practice of nonpar banking. The plan worked: the Federal Reserve developed an efficient payments mechanism and, by 1976, there remained only 64 nonpar banks in the country. By 1980, the number had dwindled to one.

Consequently, nonpar banking and related clearance fees were considered to be obstacles to the development of an efficient payments mechanism. For this reason, the Federal Reserve traditionally did not charge direct fees for check clearance or other services. Investment earnings on member banks' noninterest bearing reserve balances were generally sufficient to defray the cost of such services. In this climate, the Federal Reserve developed a uniform and efficient clearance mechanism for paper checks. Nevertheless, as we moved out of the era of paper based payments and into the more efficient realm of electronic funds transfers, the Federal Reserve began to incur costs in excess of earnings on reserve balances, creating pressure for additional revenues. In this context - working from an established payments system rather than from the chaotic circumstances existing at the turn of the century - the absence of clearance fees for the processing of payments began to be regarded more as an impediment to, rather than as a facilitator of, improved efficiency. Thus, the attitude toward clearance fees has come full circle, as demonstrated by the enactment of the Monetary Control Act of 1980 mandating the establishment of fees for various Federal Reserve services.

C. Electronic 'Checks'

The advent of the computer has permitted the financial industry to replace the multistage routing of paper checks with more direct electronic messages. Currently, electronic transfers are still in an embryonic state. The most developed system is the

Automated Clearing House (hereinafter ACH), which permits repetitive transfers of small dollar amounts, such as payroll, to be collected on a single magnetic tape and processed in "batches." Once reduced to magnetic tape, the entire batch is delivered directly to the payor's bank, thus bypassing initial delivery to the payee. The tape is then forwarded to an ACH, where computers sort incoming files from all paying banks and create outgoing files that are delivered to receiving banks according to a precise schedule. The use of direct deposit through the ACH system as a substitute for paper based checking has produced considerable savings in both banking and administrative costs. Companies originating payments have reduced costs by as much as $0.45 per transaction, while receiving companies are saving as much as $1.23 per transaction. The federal government is rapidly moving toward the use of direct deposit as a substitute for checks, with expected annual savings of $100 million by 1990.

Another, more recent advance in electronic checking is the development of debit cards that can be used either to withdraw cash from an automated teller machine (hereinafter ATM) or to transfer funds through remote point of sale (hereinafter POS) terminals located in retail establishments. ATMs offer customers 24 hour access to their bank accounts through remote walk-up terminals. ATMs may be used to withdraw or deposit cash or, more recently, to make account balance inquiries, pay bills and transfer funds between accounts. Customers gain access to the system by inserting a debit card into the terminal and entering a secret personal identification number. User-friendly programs then direct the customer with a series of questions. So far, public response to ATMs has been encouraging. From 1980 to 1985, the number of ATMs quadrupled to over 52,000 machines, with over 120 million ATM access cards outstanding.

One step beyond ATMs, POS terminals, located primarily in grocery stores, gasoline stations, and other retail establishments, permit a customer to pay for purchases by inserting a debit card into a terminal and entering a secret identification number. The electronic message is then transmitted from the remote terminal over telephone lines to a bank, clearinghouse, or other "facilitator," which in turn arranges for the debiting and crediting of payment between the customer's and merchant's bank accounts. Confirmation of the payment is then transmitted by the facilitator back to the remote terminal, where a receipt is issued for the purchase. Curiously, although the more than 6,400 POS systems offer more advanced services than traditional checking and ATMs, customer response has been lukewarm. This attitude is expected to change as familiarity with ATMs acclimates consumers to electronic payment systems.

D. Wire Transfers

Even before the development of the Federal Reserve System, wire transfers provided a quick, safe method of transferring large dollar amounts. Originally made over telegraph lines, wire transfers today are made primarily through four transfer networks: FedWire, the Federal Reserve's wire transfer system; CHIPS

(Clearing House Interbank Payment System) operated by the New York Clearing House; Cashwire, operated by a consortium of banks; and CHESS (Clearing House Electronic Settlement System), operated by the Chicago Clearing House. The dollar amount of wire transfers is staggering. For example, in the first quarter of 1982, FedWire alone averaged 220,000 transfers per day with an average daily volume of $638 billion, or $168 trillion annually. Transfers over the remaining wire services increase the annual total to roughly $200 trillion. Add to that figure payments by paper checks, ACH, POS, and ATMs in excess of $20 trillion, and the total noncash payments base in the United States is roughly $220 trillion. Therefore, the United States payments mechanism offers a ready-made revenue base of enormous proportions.

III. The United States 'Par' Fee

In order to review the proposed "par" fee on payments moving through the United States payment mechanism, the following discussion focuses on four major themes: the underlying theory of the par fee; the potential revenue effect; the incidence of the fee; and various administrative considerations.

A. Underlying Theory

The proposed U.S. par fee would be a user's fee levied on the transfer of funds through the United States payments mechanism. The general theory of user fees is well-established. As Treasury Tax Legislative Counsel Rollyson recently stated to the Senate Finance Committee, "[f]ees imposed for the use of federal government property or services. . . are an appropriate means of compensating the federal government for the expenses incurred in making such property or services available to the public." In the case of funds transferred through the United States payment mechanism, the government not only provides direct clearance services, but also monitors and regulates the overall payment mechanism. The governmental service in providing efficient and secure payment channels is a direct benefit to all economic participants, and one for which a user's fee would be justified.

Although in the nature of a user's fee, rather than a tax, the par fee proposal would seem sufficiently revenue-related to require the fee to bear some relationship to one's "ability to pay." Implicit in this proposal, then, is the premise that the degree to which one participates in the economy by transferring and receiving funds through the country's payments mechanism is an accurate measure of ability to pay. By targeting actual cash flow, the par fee would encompass transfers made for any purpose, including amounts paid as income, consumption, gift, loan, or bequest. In isolation, each of the foregoing categories of payments has been relied upon individually as a viable index of ability to pay for tax purposes. For example, funds received as income are taxed under the federal income tax; when consumed, they often are subject to a state sales tax. Funds transferred as gifts and requests are subject to federal gift or estate tax, and the lifetime consumption tax recently proposed by The Brookings Institution would tax funds that are loaned. In practice, then, many of the purposes for which funds are transferred already are targeted by a myriad of isolated tax systems, each predicated on the ability to pay. The par fee would coordinate the various theories into a single system, marshalling them in collective support of a comprehensive, low rate fee directed at the lowest common denominator of the economic process - the transfer of funds.

B. Potential Revenue Effect

The potential revenue impact of a par fee is a function of the size of the revenue base and the effective average fee rate.

1. The Revenue Base. The objective of the comprehensive par fee system is to capture the largest possible revenue base. Therefore, the base is defined broadly to include all transfers of funds made through the payments mechanism. The payments mechanism, as noted, includes all payments made by paper or electronic check, including ACH, POS, and ATM withdrawals; all wire transfers; and would include any other payments made through the Federal Reserve, as well as through any private bank, clearinghouse, or other local facilitator. For obvious practical reasons, cash transactions would not be included in the revenue base, although cash deposits and cash withdrawals by check or ATM would be included.

To avoid multiplicity of fees, a single transfer would include any intermediate transfers in the bank clearance process necessary to move funds from the originator to the destination account. In addition, the par fee would provide no exemption or distinction based on the identity of the account owner, nor on the purpose for which the transfer is made. Implicit in this feature is the possibility for fees when a single taxpayer owning two accounts transfers funds from one account to the other. Rather than exempt situations in which a taxpayer in effect transfers funds to himself, it would seem more prudent to build flexibility into the system by encouraging the continued development of universal accounts offering various investment options, and checking/debit card access. Otherwise, complex questions immediately arise concerning the treatment of transfers from wholly owned accounts to joint accounts, to escrow accounts, and to trust accounts when the taxpayer enjoys legal, but not beneficial, ownership.

Another consequence of denying exemptions from the par fee is that religious, charitable, and other organizations presently exempt from federal income tax would not be exempt from the par fee. As a preliminary matter, denial of religious-based exemptions does not violate the First Amendment's free exercise clause. Uniform levies on religious organizations, if incidental to a broader scheme of fees, is permissible. In fact, denial of exemptions for these groups probably advances their long-term interests, as experience with the income tax has demonstrated. In an environment of high tax rates, income tax exemptions have become too precious, providing the IRS with a degree of leverage perhaps unanticipated when the exemptions were introduced. Originally designed to preserve church and state independence, tax exemptions have created an atmosphere of de facto control. From the government's perspective, a climate of high taxes and the responsibility to review tax exemptions has thrust the IRS into the forefront of controversial issues unrelated to the collection of tax. As Justice Powell recently observed: "[The IRS's] business is to administer laws designed to produce revenue for the government, not to promote 'public policy.'. . . It is not appropriate to leave the IRS on the cutting edge of developing public policy." The denial of par fee exemptions, together with lower rates under a modified flat rate income tax system, would help extricate the IRS from the cutting edge of policy development, promote greater independence of tax-exempt organizations, and keep downward pressure on rates for all taxpayers.

Finally, the par fee should be structured to accommodate international transfers. An international transfer would be determined by reference to the geographical situs of the accounts. By relying on geographic situs as a touchstone for jurisdiction, the par fee would more readily conform to prevailing world attitudes that have been somewhat irritated by America's attempt to tax citizens on worldwide income regardless of physical residence. For both inbound and outbound transfers, the United States par fee would be imposed at the full rate, but there would be a credit of up to one-half the par rate for any fees actually paid to a foreign government, a feature likely to promote par fees abroad. Efforts by United States taxpayers to avoid the fees by using foreign accounts are best discouraged by keeping fee rates low, thereby minimizing the incentive to cheat, and by the imposition of penalties for purposeful evasion. Moreover, if the par fee proved to be successful, other nations might introduce similar systems, further reinforcing the integrity of the United States system. Thus, with the revenue base defined comprehensively, the par fee is likely to capture most transfers cleared through the United States' payments mechanism. Conservative estimates place that revenue base at roughly $220 trillion per year.

2. Fee Rate Schedule

Because of the comprehensiveness of the revenue base, the par fee rate schedule must be structured to accommodate not only the innumerable daily transactions made by consumers, but also the large institutional transfers made by banks, corporations, and government. In designing the contour of the par fee rate schedule, it is noteworthy that a progressive rate structure (having incrementally higher rates relative to increases in the size of payments) would have a heavy impact on institutional transfers and would create an incentive to split payments to avoid higher rates. If, as with the income tax, progressive rates were predicated on the amount of economic activity reported annually, the par fee would interfere dramatically with the timing of payments, particularly at year end. By contrast, a rate schedule structured regressively (with incremental rate reductions for larger payments) would alleviate the burden on institutions, but also would encourage bunching of payments and similar timing maneuvers, at the expense of neutrality. And whether the rates were progressive or regressive, they would have to be indexed to the economy to prevent distortions in the burden due to inflation or deflation. Consequently, as a workable compromise, the par fee would be levied at a proportional rate, similar in operation to exchange fees formerly imposed by nonpar banks.

One major exception to the general proportional rate, however, would be necessitated by the need to accommodate large institutional loan transactions of short duration. For example, at a federal funds rate of 10 percent, the fee on an overnight federal funds loan would be four times the earnings on the transaction. To avoid this confiscatory effect, and the resulting disruption of the financial markets, the par fee must be reduced or eliminated on large loans of sufficiently short duration. For example, large loans having maturities not exceeding one week might be exempted entirely from the par fee, with successively higher rates for maturities between two and four weeks, four to six weeks, and the full rate thereafter.

Applying a general par rate of one-twentieth of one percent, the burden on a consumer buying $100 worth of groceries would be $0.25; a weekly paycheck of $500 would yield $0.25; an $800 monthly mortgage payment, $0.40. A $10,000 automobile would cost an additional $5 and buying $100,000 of securities would result in an additional cost of $50. At the institutional level, the par fee on purchasing $500,000 of equipment would be $250; a $2 million capital improvement would cost $1,000 and a $40 million office building would cost an additional $20,000. Although the burden on institutional transfers (other than certain short term loans) at first blush seems large, in actuality a par fee of one-twentieth of one percent is the functional equivalent of less than two days' investment float. Furthermore, most of the fees would be payable by taxpayers in the best position to defray the cost by using emerging payment technologies to maximize the efficiency of their cash management.

C. Incidence of the Fee

Incidence of the par fee would be controlled by the parties to a transfer-a flexible, market oriented approach that accommodates the relative bargaining strength of the parties, provides a further buffer against heavy burdens at the institutional level, and facilitates payments when the recipient has need of a particular net amount. For example, under this market oriented system, either the transferor or the transferee could agree to pay the entire fee, to split the fee between them, or to share the fee in any other desired manner.

In the case of wire transfers, the transferor would control the incidence of the fee by an appropriate direction at the time of transfer. Similarly, par fees on payments through retail POS terminals would be controlled by the transferor's contemporaneous direction at the point of sale. ATM cash withdrawals would cause the fee to be deducted from the customer's remaining account balance, similar to other transaction fees. In the case of checks, incidence of the fee would be imposed on the transferor unless the transferor marked a box on the face of the check shifting part or all of the burden to the transferee-a simple, self-policing feature. As with other payments, fees on check payments would be imposed and collected as the item moved through the payments mechanism. In any situation, a shift of fees to the transferor would be respected unless the transferor maintained insufficient funds (or credit) to pay the fee, in which case the command would be overruled and the fee would be deducted from the payment.

D. Administrative Aspects of a Par Fee

There are a number of administrative aspects of the par fee that should be explored, including questions of compliance and collection, opportunities to coordinate fiscal and monetary policy, and certain transitional considerations.

1. Compliance and Collection. As suggested earlier, the par fee would be collected automatically as payments are cleared through the United States payments mechanism. Revenues collected by private banks and other intermediaries would be remitted immediately to local Federal Reserve Banks, which already are empowered to collect revenues as fiscal agents of the United States Treasury. Indeed, a primary virtue of the par fee is its reliance on existing mechanisms and procedures to collect and enforce the fee, offering considerable start-up and operational savings when compared to various other revenue proposals.

A primary benefit of the par fee to taxpayers would be the absence of any self-assessment process-eliminating the cost of maintaining additional records, preparing returns, and avoiding the related anxiety of coping with complex revenue systems enforced with severe penalties. With the par fee, auditors would focus their efforts primarily on the payments mechanism. Compliance efforts would be concerned largely with the volume of activity between accounts, not with the purpose of the transfer or the identity of the account owners. Financial privacy, which has been threatened by the intrusiveness of the income tax, would not be placed in further jeopardy by the par fee.

As for evasion, it seems unlikely that the negligible burden of the par fee ($0.05 per $100) would drive any additional taxpayers into the underground cash economy. In fact, by alleviating pressure on the income tax to raise additional revenue, the par fee would facilitate transition to a modified flat rate income tax, thus helping to return alienated taxpayers to the mainstream economy. At the institutional level, the use of barter would effectively allow avoidance of the par fee (albeit not the income tax), but, given the inherent inefficiency in valuing barter exchanges and the costs of exchanging goods in kind, it seems unlikely that the par fee would drive companies out of the traditional payments mechanism.

2. Coordination of Fiscal and Monetary Policy

A United States par fee would provide a new and powerful dimension in the effort to coordinate fiscal and monetary policy.

With the par fee collected by the Federal Reserve, it would be possible to delegate either to the Treasury or to the Federal Reserve limited authority to monitor par fee rates and adjust them periodically across a predetermined narrow range as economic circumstances require. This would help to alleviate the constant pressure on congressional tax writing committees to adjust fiscal policy through crude, poorly targeted statutory provisions. Thus, it would provide a subtle tool of fiscal control, coordinated closely with monetary policy from a more politically isolated vantage point, reinforcing the long-term integrity of the system.

3. Transitional Considerations.

Transition to a par fee would be extremely smooth. Unlike the value-added tax, the par fee is designed to take advantage of existing regulatory and collection machinery. It requires no extensive new bureaucracy to administer the fee and no additional effort by taxpayers to pay the fee. If the par fee proved unsuccessful, no great investment would be lost if it were abandoned. Unlike a value-added tax or a national sales tax, the par fee has virtually no preemptive effect on state taxing schemes. Accordingly, there would be relatively little risk or expense in making a transition to (or out of) a par fee system.

More importantly, as mentioned above, revenues generated by a par fee would facilitate the difficult transition to be expected as we move from the present income tax system to a modified flat rate system, which remains the centerpiece of present tax reform efforts. Indeed, transitional concerns with the modified flat tax proposals are posing some of the greatest political obstacles to their enactment. The par fee, while producing no transitional problems of its own, offers an effective catalyst for the transition to a modified flat rate income tax system.

IV. Tax Policy Evaluation of the Par Fee

If the par fee were a tax rather than a user's fee, it would have to satisfy the traditional goals of tax policy. As noted earlier, it seems reasonable to subject the par fee to similar requirements. At least four criteria traditionally are employed in evaluating a particular revenue measure. First, it should be simple and easily understood by those who must comply with its terms. Second, it should be equitable, imposing equal burdens on similarly situated taxpayers (horizontal equity) and proportionately different burdens on taxpayers in different financial circumstances (vertical equity). Third, it should be efficient; that is, it should be a neutral consideration in the allocation of resources and an effective method of raising revenue. Finally, it should be a responsive tool of fiscal control in order to help stabilize fluctuations in the economy. The following discussion evaluates the par fee proposal in terms of these traditional objectives of revenue policy.

A. Simplicity

It is difficult to imagine a revenue measure any simpler than the par fee. It is easy to understand and easy to pay. Unlike the value-added tax, the par fee would require no complicated regulatory or compliance system. Instead, it would take advantage of the highly refined payments mechanism that is already in place. As a result, the fee would be easy for the government to administer, and easy for business and other taxpayers to pay, a feature that should avoid tipping the precarious balance that presently exists between the government and those taxpayers pushed to the verge of revolt under the present income tax system.

B. Equity

The par fee tends to be fair because it treats similarly situated taxpayers the same, while differentiating between taxpayers in different economic circumstances. For example, under the income tax, deductibility of interest on home mortgages places tenants with equal earnings at a competitive disadvantage. Similarly, complete tax exemption for municipal bond interest, preferred rates for capital gains, and regular rates for wages and other income create enormous disparity in the income tax burdens of those taxpayers who are similarly situated. Under the par fee, by contrast, all of the foregoing payments would be affected identically.

In the business sector, firms operating at the same ratio of payments-to-earnings would experience similar par fee burdens. For example, a capital intensive firm would pay the same fee on a purchase of equipment that a service firm would pay on a commensurate amount of payroll. For firms relying more heavily on the payments systems for their livelihood, such as financial institutions, the burden potentially would be greater. This threat is mitigated, however, by operation of the special short term maturity exemption, discussed earlier, and by the special ability of such firms to defray the par fee through greater innovation in cash management and payment techniques.

Another consideration is the potential for the par fee to pyramid, with the final purchase price of a product reflecting fees accumulated at each step in the flow of goods. However, in light of the numerous determinants of price movement-including price elasticity, foreign exchange rates, and opportunities to defray par fees through better cash management-the inflationary impact of a par fee might well be only negligible, particularly when compared to the impact of a value-added tax. If significant compounding did occur, the tax might encourage corporations to integrate vertically in order to cut their production costs. The extent to which the par fee would reward vertical integration of operations depends on the number of steps that integration could eliminate, and the countervailing business, legal and economic forces that prevented greater concentration in the past. Given the multitude of factors bearing on the decision to integrate, it seems unlikely that introduction of a par fee would precipitate a broad migration toward greater concentration.

In terms of vertical equity, the par fee would be levied at a proportional rate. Proportional sales taxes are generally regarded as regressive because poorer individuals must spend a greater proportion of their earnings than wealthier people. With the par fee, by contrast, the proportional levy is likely to be fairly progressive in operation for at least three reasons. First, the exclusion of cash transactions from the par fee base (like the zero bracket amount under the income tax) is likely to be a progressive feature favoring the poor, who rely to a greater extent on small cash transactions. These are the same people least likely to maintain a bank account or use a debit card. Second, a proportional sales tax is regressive because it targets an activity-consumption-that tends to level off at a certain point. A par fee, by contrast, encompasses a vastly more comprehensive revenue base that does not level off. In fact, the exercise of economic power through the transfer of funds generally expands with improvements in one's economic position. Finally, because the great majority of funds in this country are transferred at the institutional level, most par fees would be drawn from institutional traffic, hardly a regressive feature. Thus, poorer individuals would pay virtually no par fees, middle-income groups and small businesses would pay fairly modest amounts, and large institutions-those best able to defray the fee through efficient cash management-would contribute the largest share. The proportional par fee, then, is likely to be fairly progressive in operation.

C. Efficiency

A revenue measure is efficient if it is a neutral factor in the allocation of resources, and an effective revenue raiser. Given the breadth of the par fee base and the fee's negligible rate, the fee is not likely to have any significant impact on the allocation of resources at lower and middle economic strata. At the institutional level, however, the par fee probably would promote greater use of advanced electronic payments mechanisms and more sophisticated cash management techniques (at least for those firms concerned with losing the functional equivalent of two days' investment float). For example, utility companies might defray the par fee by ferreting out and exploiting wasted collection float, such as that encountered in processing multitudes of checks from a large customer base. Aggressive promotion of a prearranged direct deposit program, in conjunction with area banks, could reduce collection float by several days-more than compensating for the par fee, while not costing the individual consumer anything of concern. Thus, to the extent the par fee causes any distortions, it might actually be a positive factor encouraging greater market efficiency.

Moreover, the par fee is likely to be a cost efficient revenue raiser. As noted earlier, the fee is based on an existing array of well-tuned payments mechanisms, and would position us to take advantage of any new payment technologies that might arise in the future. The fee would be collected automatically and remitted immediately to the closest Federal Reserve Bank, providing a smooth and predictable source of revenue. The par fee should not require any additions to the federal bureaucracy, or any significant increase in federal regulations. From the taxpayer's perspective, the par fee would avoid the expense and inconvenience of the self-assessment process and should facilitate the transition to a more efficient modified flat rate income tax system. As improvements in the general tax climate draw disaffected taxpayers back into the mainstream, greater efficiency would appear in other areas of government. For example, court and administrative dockets now encumbered by numerous tax protestor cases and tax shelter litigation would be relieved substantially. The economy as a whole would benefit by having citizens and businessmen less preoccupied with the possible tax ramifications of their decisions and more in tune with the forces of the marketplace.

D. Stability

A final objective of any revenue system is to promote economic stability. In this respect, the par fee is likely to provide a significant advantage over other methods of raising revenue. First, the par fee would penetrate deeply into the fabric of the economy and should produce a steady, smooth flow of revenue. Greater predictability in revenues should improve the budgeting process, providing greater stability in government programs.

More importantly, the par fee could be used as a subtle tool of fiscal control, in close coordination with monetary policy, to stabilize the economy as a whole. Currently, changes in fiscal policy depend on the tax legislative process, a laborious, politicized effort that can take months or years to complete. With the par fee, by contrast, the Secretary of the Treasury or the Federal Reserve (as fiscal agent of the Treasury) could be vested with independent statutory authority to monitor and adjust par fee rates across a narrow, predetermined range. Adjustments in the par fee could be made at short intervals in close coordination with changes in monetary policy. The result would be a powerful new dimension in the government's effort to stabilize the economy.

V. Recommendation

A federal system of "par" fees would raise revenue to combat the deficit and facilitate the transition to a more moderate income tax. Because the par fee is directly related to the specific governmental service of providing efficient and secure payment channels to all economic participants, it is most accurately characterized as a "user's fee" rather than a tax. As such, a system of par fees could be implemented without compromising the President's or this Committee's pledge not to raise taxes.

For the foregoing reasons, it is respectfully recommended that this Committee consider this proposal for a federal "par" user's fee for further study.

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* Footnotes and supporting references available on request.

The CHAIRMAN. Senator Long.

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. No questions, Mr. Chairman.

The CHAIRMAN. I am intrigued, Mr. Newman. It is the first I have heard of your idea, because it is based upon transactions and is based upon the value of the transaction and the electronics transactions, you indicate that it probably is progressive because the poor simply deal mostly in cash transactions. Either they can't get credit or they don't have credit cards. Do I read you correctly?

Mr. NEWMAN. That is one reason. There are a couple of other reasons why I believe it would be progressive in operation. Like the sales tax the user's fee is proportionally levied; but the sales tax in operation is regressive because it targets consumption, which is an activity that levels off with improvements in one's economic position. The par user's fee, however, targets the exercise of economic power, which does not level off, but in fact increases with improvements in one's economic position. So, I think that although it is levied like a sales tax at a proportional rate, in operation it would be fairly progressive.

Second, most revenues would be derived from institutional traffic which is hardly a regressive feature. With regard to the burdens on the institutions themselves, they are in the best position to defray the fee either through improvements in cash management or—and I noticed on the first page of the second section of the Wall Street Journal today there was a discussion of opportunities to tighten up cash management through electronic fund transfers. So I believe for those three reasons—the two that I mentioned and the one that you mentioned—it would be progressive in operation.

The CHAIRMAN. You say over 90 percent of all payments in this country—$220 trillion—pass through these automated payment systems?

Mr. NEWMAN. I believe that is a very conservative estimate.

The CHAIRMAN. Conservative to percent or as to the quantity of transactions?

Mr. NEWMAN. In terms of quantity. I used the most conservative estimate I could find. A more likely estimate is that it is somewhere between $250 and $300 trillion per year right now.

The CHAIRMAN. So, this applies to an absolute breadth of circumstances. I mean, it is a very broad tax in that sense.

Mr. NEWMAN. It is the most comprehensive tax base imaginable, which of course supports the low rate, which can be defrayed through tighter cash management.

The CHAIRMAN. Let me ask Mr. Huard something. Based upon the standards in your appendix for a consumption tax, Mr. Huard, does Mr. Newman's idea meet all of your standards?

Mr. DEWAR. Obviously, I am not sure I understand all of his proposal, but the concept of a very, very broad tax——

The CHAIRMAN. I meant Mr. Huard.

Mr. DEWAR. I am sorry.

The CHAIRMAN. Obviously, your names are sufficiently similar that I must pronounce them correctly.

I am looking at your appendix, Mr. Huard, ad valorem, broadest possible, fullest coverage of services, appropriate adjustments to mitigate income. His concept seems to fit all of your standards.

Mr. HUARD. I would have to say on first glance that, yes, it does. Not having ever heard of this concept before or thought of it before the last seven minutes, I would have to say that it appears to cover all the bases; and it certainly is a low rate.

The CHAIRMAN. Mr. Newman, who are you? [Laughter.]

How did you get here? Of all the hundreds of people that wanted to testify, how did you get on?

Mr. NEWMAN. Maybe I should just say that I am the husband of she who must be obeyed; but I am just an individual tax attorney who has been interested in tax reform for several years and I felt that it was one thing to criticize the efforts of Congress; it was something else to come up with a creative solution to the problems.

The CHAIRMAN. Is there an organization that promotes this, you know, like the Esperado, or Universal Language, or Flat Worlders, or something like that? [Laughter.]

Mr. NEWMAN. If there is, it is a committee of one; and I am not affiliated with any other group or entity. I have no hidden agenda, and I am just putting the idea forward for consideration.

The CHAIRMAN. You don't suppose it would have a tendency to make us all deal in cash?

Mr. NEWMAN. I don't think so because—and I covered this in the footnotes—in the October 14 edition of Tax Notes magazine, there are substantial footnotes supporting this proposal; but I don't think it would drive any additional taxpayers out of the mainstream economy simply because the rate is so low, because of the security and additional costs of dealing in cash.

The CHAIRMAN. So, the only people that would deal in immense quantities of cash are those who currently deal in immense quantities of cash?

Mr. NEWMAN. That is right.

The CHAIRMAN. Nothing is likely to change that.

Mr. NEWMAN. And I think it is worth pointing out that, although cash transactions between individuals would not be subject to the fee, cash deposits—for example, illegal drug money laundered through banking institutions—would be taxed or subject to the fee so that——

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Knowing the chairman was prepared to fall for just about anything——

[Laughter.]

Senator DURENBERGER. No, let me ask you a couple of questions that deal with some of the imolementing mechanisms. On page 24 of your testimony, you suggest that the Federal Reserve or the Secretary of the Treasury should be granted the authority to adjust the par fee within what you call in there a predetermined range.

Now, considering the vast power of the Federal Reserve Board to determine monetary policy in this country, what do you think about giving such an extension of power to the FED; and wouldn't that concentrate just one whale of a lot of power in an independent board?

Mr. **Newman**. That is certainly one consideration. That is why I proposed alternatives. It could be implemented through a number of ways. One is through an amendment to the Monetary Control Act of 1980, which I understand is not within the scope of this committee's authority; but another alternative which would be within the scope of this committee's reach would be an amendment to the Internal Revenue Code; and pursuant to that, creation of legislative regulations delegating this authority to the Treasury.

As a third alternative, and something I have since thought up, would be to create a new committee staffed by—you would have to have an odd number of people on the committee to prevent a tie—possibly two members appointed by the Senate, two members by the House, and three by the President.

Senator **Durenberger**. It looks like a proposal like this would primarily affect the large interbank transactions. What does this do by way of increasing the incentives for bank transactions to move offshore?

Mr. **Newman**. I am sorry. I couldn't hear the last part of your question.

Senator **Durenberger**. What does this do by way of incenting the movement offshore for some of these larger banks that would be subject to this?

Mr. **Newman**. I would anticipate that—now, one aspect of the proposal is its treatment of international transfers. And to answer your question fully, an international transfer would be determined by the geographical situs of the accounts, an approach that more readily conforms with prevailing world attitudes, according to tax jurisfiction, as opposed to the approach with the Federal income tax to tax all worldwide income. And on an international transfer—either an outbound or an inbound transfer—the fee would be levied at a full rate, but there would be a credit of up to one-half the rate for any fee paid—any similar fee paid—to a foreign government. I think that is a feature that is likely to promote similar systems abroad, and to further shore up our own system here.

With regard to just outright cheating, that problem has always been addressed by penalties for the purposeful evasion. And then the question is what the incentive would be to cheat; and with the rate levied at such a small rate, I think it is much less than some similar fees levied by foreign countries like Switzerland for the transfer of funds.

So, there are a number of obstacles to further tax evasion.

Senator **Durenberger**. Pages 10 and 11, you recognize that a transfer between a wholly owned account to a joint account or to an escrow account should not be subject to the par fee. And you recommend that universal accounts allowing various investment options would alleviate the pyramiding of the par fee. Won't this, in effect, tend to increase the concentration in the financial services industry and give consumers and business fewer options for investing?

Mr. **Newman**. I think momement is towards greater deregulation of the industry; and with the State or condition of a lot of smaller institutions, especially in the Farm Belt, the way it is, I think it is very likely you are going to see concentration——

Senator **Durenberger**. This isn't going to speed up that process?

Mr. NEWMAN. I think insofar as deregulation will provide additional alternatives to defray the fee by financial institutions and by individuals through better cash management that will go hand-in-hand with deregulation; and because of that, deregulation would be beneficial. It would work well with this proposal.

Senator DURENBERGER. Do you have any idea what the average par payment annually would be made by the average middle income taxpayer? Have you got those figures?

Mr. NEWMAN. It is hard to say; but let's just say they had a total of $100,000 of economic activity. The rate on that would be about $10.

Senator DURENBERGER. Does it happen every time somebody uses their credit card, for example?

Mr. NEWMAN. What you do is you just watch the cash flow 'If you make a purchase by credit card, there is going to be a reimbursement to the merchant from the bank, and that would be subject to the fee. And then, when the consumer pays the bank pursuant to the monthly statement, there would be another fee levied at that time.

Senator PRYOR. Does Senator Long want to ask a question?

The CHAIRMAN. Yes.

Senator PRYOR. Is this his time?

The CHAIRMAN. We are on the second go-around, and he is first.

Senator LONG. Let me just ask this. To your knowledge, is any other nation or State doing something of this sort, something along this line?

Mr. NEWMAN. No. I think I invented it. [Laughter.]

Senator LONG. It is a very interesting idea. May I say that I was sort of dozing about the time you read this——

[Laughter.]

Senator LONG. And it wasn't until the room became very agitated by the chairman's questions that I began to take interest in this. I sat down and read this thing, and it is very interesting, and it deserves some very careful thought. It just might be a great idea.

Mr. NEWMAN. I should mention that the footnotes are about 40 pages long, and I answered a lot of the collateral questions that have arisen during the last 3 years through just discussing it informally with friends and including discussions of the direct tax clause under the Constitution—the impact on the first amendment, on exempt entities, just a whole littany of questions that popped up.

So, there is a lot more research that went into this proposal, and it is reflected in the 25-page text——

Senator LONG. Let me ask you this now. Does this proposal suggest that in these currency transactions—and I have seen how a little of that is done—they trade on a very, very small margin in moving currencies back and forth and around. Would those transactions be taxed by this?

Mr. NEWMAN. Yes, they would. Now, at the rate of 1 basis point, or 0.0001, I don't believe there would be any need for any exemptions. The only exemption that I can think of that would be required is when the fee is increased to the area of 5 basis points, or 1/20th of 1 percent.

And an exemption would be needed on overnight Federal funds loans or other short-term loans with the large principal amount. Otherwise, the fee would be confiscatory, and the fee would be larger than the earninps on the transactions. But with that sole exception—and that is one reason why I used a very conservative estimate here on the tax base—that is the only exception mandated by economics, and I would not recommend that any exemptions be added for social policy purposes.

Senator LONG. Now, have you discussed this idea with some of those who do have those huge amounts of currency transactions? The reason I am asking is that my impression is that they trade in fantastically large amounts of money to make a very, very small profit. And I just wondered if you had discussed it with some of those big banks——

Mr. NEWMAN. I have submitted——

Senator LONG. Do you do a lot of that type of thing?

Mr. NEWMAN. I have submitted earlier drafts of the proposal to a number of top policymakers and was fortunate to receive generous comments from people in private industry, at central banks and on Capitol Hill, even in the administration. I would prefer not to mention any names because their generosity would be betrayed by my taking advantage of it at this pnint, and I would like to keep the avenues of communication open.

But it has had some public comment and review; and I have learned a lot in the process. It has been difficult to take criticism, but I have tried to learn from it and keep improving it.

Senator LONG. Let me iust ask this question. I just want to ask Mr. McGlotten over there. It doesn't sound like that would put much tax on a working man, Mr. McGlotten. Do you have any objection to it on behalf of your people?

Mr. MCGLOTTEN. Senator Long, at first blush, I would say it is a very interesting proposal. Certainly, we would have to sit down and take a look at it and see what the real long-term effects would be. I guess the one thing I have in my mind—and my colleague here is chief economist for the AFL-CIO and he would have—is that in terms of the number of transactions, there are a number of certainly small transactions that clearly, if you are talking about 000.1, you are talking about 200 trillion transactions?

And I guess the question I would raise is the question that he just answered for you, Senator Long, which was the whole question of eliminating very, very big transactions. Does the revenue really come forward? But I can certainly understand in terms of the quantity of transactions clearly we are going to get a number of dollars; but we would have to take a very hard look at it; but at first blush, it is very interesting.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Have you ever talked to Senator Domenici about this? [Laughter.]

He wants to see you at 4:30. [Laughter.]

Word travels quickly. Seriously, Mr. Chairman, Mr. Dewar of K mart was going to have a comment on this, I think; and I would be interested in hearing his comment; and then I want to ask one or two quick questions.

Mr. **Dewar**. Mr. Chairman and Mr. Pryor, I am sorry. I thought I had spoken to it before.

The **Chairman**. That was my mistake.

Mr. **Dewar**. But generally, the point I was making is that it does sound like the very broad proposal—the spreading of the base, the reduction in rate—which we believe strongly should be the feature of the tax reform proposal. So, without understanding all of its ramifications, on the surface it certainly sounds like a better approach than that of nondeductibility of excise taxes on low-priced apparel which inevitably is going to thrust the costs of those increases onto the lower earning consumer in the United States. Generally, I am in favor of it.

Secondarily, it sounds of interest because it doesn't have the concerns that I expressed regarding the trade issue, which I think is a very important and inherent part of the nondeductibility proposal.

Generally speaking, I would be in favor of exploring that. I would hope the committee would look further into it.

Senator **Pryor**. Thank you. Mr. Newman, who would be opposed to this proposal? Tell me the type of group or association that might oppose this.

Mr. **Newman**. I really can't. No group or association comes to mind.

Senator **Pryor**. You are in bad trouble then in this town. [Laughter.]

Mr. **Newman**. Quite frankly, the fee would be, because of some market mechanisms I mentioned in the incidence of the fee, would only be paid more or less by those persons or entities who are not sufficiently bothered by it to defray it through better cash management or through greater reliance on improved payment techniques.

So, it would only be paid by those who aren't bothered by it; and that is the best kind of system. It is self-regulating in that sense.

Senator **Pryor**. Very intriguing.

The **Chairman**. It is very intriguing.

Senator **Pryor**. It was someone like this, I think, Mr. Chairman, who came up with the idea of the hula hoop years ago. [Laughter.]

He just came up with the idea and revolutionized the whole world. Fascinating. Thank you.

The **Chairman**. Any other questions?

[No response.]

The **Chairman**. If not, gentlemen, thank you very much. We are adjourned until 9:30 in the morning.

[Whereupon, at 4:28 p.m., the meeting was recessed, to be reconvened at 9:30 a.m., on Tuesday, April 22, 1986.]

Statement of Senator Paul S. Trible (R.-Va.)

I appreciate this opportunity to state my total opposition to ending the deductibility of excise taxes.

Excise taxes are a cost of doing business and are appropriately deductible in determining taxable income.

Ending deductibility would tax businesses on more than their net income and would force businesses with no income--or even losing money--to pay tax. These outcomes are unacceptable.

Ending deductibility will dramatically increase existing excise taxes. Consumers and products already most heavily burdened by excise taxes would suffer dramatically increased burdens.

Tax reform should improve the fairness of the tax code by aligning tax burdens with "ability to pay", and encourage an efficient economy.

Eliminating deductibility does neither.

People earning the same incomes would be more unequally taxed, as will industries with differing input mixes. Some well-to-do taxpayers would escape the tax increase while many who are poor would pay more. Market distortions would multiply.

The huge new revenues raised by nondeductibility would not finance tax reform but rather retention or expansion of the very tax preferences which make our current tax code so unfair and inefficient.

Ending deductibility would diminish state and local excise revenues, at a time when those governments are already under extreme fiscal pressure.

American companies facing heavy import competition or trying to compete abroad will be badly hurt by this cost-raiser.

In short, ending deductibility of excise taxes is a bad idea on grounds of tax principle, fairness, and efficiency. It is basically an affront to the goals of tax reform. It will be very harmful to state and local governments and to Americans engaged in international trade.

I urge the Committee to reject this idea.

LARRY J. HOPKINS
6TH DISTRICT, KENTUCKY

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Congress of the United States
House of Representatives

April 21, 1986

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for this opportunity to address the Finance Committee on the proposal to eliminate the deduction for excise taxes. As the ranking member of the Tobacco and Peanuts Subcommittee of the House Agriculture Committee, this is of particular concern to me and the growers I represent.

The Finance Committee was extremely helpful last year during committee consideration of the omnibus reconciliation bill which was signed into law earlier this month. As you recall, the Committee agreed to join a proposal to permanently increase cigarette excise taxes with a proposal to reform the tobacco program administered by the Department of Agriculture. The Committee was very sensitive to the delicate balance between grower and company interests that was achieved in that bill. Unfortunately, passage of the proposal being considered today would seriously undermine, if not destroy, this compromise.

The new legislation requires companies to make a large financial commitment to the continuation of the tobacco price support and supply control program. Their financial commitment is made by agreeing to purchase surplus stocks of tobacco and by sharing equally in future no net cost assessments. Threatening the financial stability of the cigarette manufacturers will threaten the stability of the tobacco program.

During our many long hours of negotiations on this historic agreement, company representatives stated that the companies wanted to be "partners in commerce" will the growers. Passage of this proposal may destroy that relationship before it has a chance to be tested.

Again, thank you for this opportunity to share my concerns with you on this proposal.

Yours very truly,

LARRY J. HOPKINS
Member of Congress

LJH/mk

Statement
of
The Honorable James G. Martin
Governor
State of North Carolina

For the Record
Committee on Finance
United States Senate
Washington, D.C.

The tax reform proposals to eliminate the deductibility of federal excise taxes and tariffs as proposed by Chairman Packwood, are of deep concern to North Carolina.

This proposal, if enacted, could have a significant negative impact on North Carolina tobacco companies and our state's economy as well. Essentially the proposal would levy a tax upon a tax. A company would be taxed on excise tax revenues that it collects and sends to the U.S. Treasury. Significant price increases would be necessary to offset the loss in revenue and this would again cause excise taxes to increase proportionately due to another proposed provision of indexing excise taxes to inflation.

The doubling of the cigarette excise tax in 1983 has had an adverse effect on the economy of North Carolina. Its effects have been well documented as to the loss in sales, jobs and income of our Number One commodity - tobacco.

"North Carolina grows on tobacco." -- These words were the slogan of a public awareness campaign several years ago and they still stand true today. North Carolina last year produced more flue-cured tobacco than any comparable area in the world - over 563 million pounds. Flue-cured tobacco, also known as bright leaf, is indeed a bright and shining symbol of economic prosperity in North Carolina. Over 90,000 North Carolinians depend on tobacco directly or indirectly for their livelihood.

The State grows flue-cured tobacco in the Piedmont and Coastal Plains regions and also grows burley tobacco in the western mountain counties. The golden leaf is grown on approximately 34,000 farms in North Carolina and some type of tobacco is grown in 91 of North Carolina's 100 counties. Cash receipts from tobacco amounted to over $1 billion four out of the last five years. In

1985, 24.1 percent of cash receipts from all crops and all farm commodities came from tobacco.

At the other end of the spectrum, cigarette manufacturers in North Carolina produced over 665 billion cigarettes in 1985. That's about 50 percent of all the cigarettes manufactured in the United States. North Carolina is the largest tobacco manufacturing state in the nation.

Other sectors of the North Carolina economy also benefit from the strength of the State's tobacco industry. There are tobacco auction markets in more than 40 towns in the State. Tobacco offers a variety of other support industries: the largest cigarette paper factory in the nation; chemical and plastic suppliers; packaging and container suppliers; cigarette filter producers; fertilizer and farm equipment suppliers; transportation industries; commercial printing; advertising in the media.

All these industries produce important revenues for North Carolina and other states. Every business must earn a profit if it is to grow or even survive. Growth is another word for expansion and expansion creates the need for new workers, but expansion must be justified and largely financed by the accumulation of earnings beyond the cost of doing business; in other words, profits. If North Carolina's tobacco agriculture is successful, it not only benefits the farmer but everyone. It carries its part of the tax load, it provides more and better jobs. If North Carolina's tobacco agriculture is unsuccessful,it provides fewer and fewer jobs and less opportunities for all. North Carolina depends heavily on the golden leaf. The thousands of North Carolinians involved with tobacco are sure that the golden leaf will continue to play an important role in the economy of North Carolina and the life of its citizens. As long as the tobacco industry from grower to consumer is allowed to continue to grow, North Carolina will grow with it.

The tobacco farmer has not shared in the economic recovery that most of the nation has experienced in the past year. In fact, a recently completed financial survey by the North Carolina Crop Report Service indicates that 42 percent of tobacco farmers experienced a loss in 1985. Beset by many problems, the tobacco grower has been particularly disadvantaged by congressional action to raise the discriminatory tax on the product on which the grower depends for his livelihood.

I hope that the tobacco industry will not be forgotten by my former colleagues when they deal with the excise tax proposals.

Additionally, I am concerned that the proposal creates a permanent preemption of an important source of state tax revenues. State alcohol, tobacco and motor fuel taxes are the third largest source of revenue for states. At a time when states are assuming major responsibilities, it is important that these revenues not be pre-empted.

I hope you will consider my concerns as you deliberate the issue of tax reform.

Congreſs of the United States
Washington, D.C. 20515

May 2, 1986

The Honorable Bob Packwood
Chairman, Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

We appreciate the fact that you have decided to hold hearings on the excise tax provisions of the proposed tax legislation pending before the Committee on Finance. We oppose those excise tax increases, including those that would result indirectly by the elimination of the excise tax deduction, and request that our letter by included in the hearing record.

The economic reality is that excise taxes are not borne by the corporations who collect those taxes and pay them to the Federal Government. Rather, there is clear evidence that excise taxes are paid by consumers. In some instances the excise tax is directly reflected in the cost to consumers. In other instances -- the various excise taxes paid by the trucking undustry are good examples -- the excise taxes become an indirect cost of products on which an excise tax is not applied directly. Of course some products are affected both directly and indirectly.

It is also true that excise taxes are inflationary since they result in price increases without any inherent increase in the value of goods purchased.

In addition, the fundamental regressivity of excise taxes has long been an accepted fact. Recent studies that show how lower income families will lose more of their income tax cut to increased excise taxes than higher income individuals confirm this well established economic reality. Moreover, the fact that excise taxes on such luxury items as furs and jewelry have been repealed exacerbate the unfairness of seeking revenue by raising the remaining excise taxes.

For these reasons, we oppose the provisions of the mark-up vehicle that would repeal the deduction for excise taxes and tariffs, that would raise wine excise taxes, and that would index various excise taxes to future price increases.

We know that the Committee will receive vast amounts of detailed testimony on this issue, including general comments and other comments more specifically directed to the affected industries. Our purpose in writing is not simply to add to a substantial hearing record. Rather, we felt you should be aware of our feelings on this matter so that the efforts of the Committee on Finance to fashion a major tax bill may take into account the view of some of us in the House on this issue.

Obviously we are pleased that the House-passed tax bill did not increase excise taxes. In the end, the purposes for which you and so many others have labored so long to overhaul the tax code could be lost by seeking to use excise tax increases as the device through which we pay for lower tax rates.

Thank you for considering our views, which we hope you will share with your colleagues on the Committee.

Yours very truly,

Richard A. Gephardt Jim Chapman Dick Cheney

Robert J. Mrazek

Tommy Hartnett

Tom Bliley

Helen Delich Bentley

Norman Y. Mineta

Arlan Stangeland

John Conyers

Trent Lott

Robert T. Matsui

Ronnie G. Flippo

Butler Derrick

James Jones

H. James Saxton

Tom DeLay

Bill Clinger

Tom Kindness

Pat Williams

Guy Vander Jagt

Jim Valentine
John Bryant

J. Alex McMillan
Sharp

Walter B. Jones

Hal Rogers
Bill Boner

James H. Quillen
Austin J. Murphy

Frank Horton Ed Markey

Tom Tauke Charles A. Hayes

Gus Savage Jim Weaver

Gerald D. Kleczka Jim Saxton

Norman Sisisky Bill Richardson

Nick Rahall

Thomas J. Manton

Bob McEwen

Ray McGrath

Vin Weber

Bill Thomas

Norman F. Lent

Bruce F. Vento

Harold L Volkmer

Steve Neal

Dan Daniel

Don Edwards

Tom Coleman

George E. Brown

Bill Hefner

Gene Snyder

Gene Taylor

Esteban E Torres

Frank Guarini
Peter W. Rodino

Mickey Leland
Bart Gordon

Dean A. Gallo
Vic Fazio

Barbara B. Kennelly
Doug Pease

Coelho

Marjorie S. Holt

Barbara A. Mikulski

Robert J. Lagomarsino

Bill Broomfield

John Paul Hammerschmidt

John J. Duncan

Ben Gilman

Jim J Florio

Tom Loeffler

Barney Frank

Richard H. Stallings

Robert C. Smith

Dunn

Matthew G. Martinez

Robin Tallon

Bruce A. Morrison

Larry J. Hopkins

Barbara Boxer

John McCain

Newt Gingrich

David S. Monson

Charles B. Rangel

Charlie Rose

Ed Madigan

Howard Coble

Bill Cobey

Richard Ray

Roy Dyson

Charlie Whitley

Mel Levine

Gus Hawkins

Carroll Hubbard

Carl C. Perkins

Tim Moody

Jim Lightfoot

Harry Reid

Tommy F. Robinson

Ron Wyden

Sala Burton

Richard H. Lehman

Edward Feighan

Howard L. Berman

David E. Bonior

Mike DeWine

Dick Gephardt

Les Aspin

William J. Coyne

Robert Torricelli

Don Sundquist

Lindsay Thomas

Rick Boucher

Sonny Callahan

Dan Burton

ASERTT

April 17, 1986

Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Chairman Packwood:

The Alliance for Simple, Equitable and Rational Truck Taxation (ASERTT) is an organization of trucking companies, independent truckers, truck leasing companies and suppliers to the trucking industry who have joined together to work for a more sensible system of truck taxation and highway finance. We are writing you on the question of eliminating the deductibility of federal excise taxes. We respectfully request that this letter be made a part of the hearing record on this issue.

Highway users in general and the trucking industry in particular are the country's largest payers of federal excise taxes. Most highway users pay an excise tax on the purchase of fuel. Truckers pay excise taxes on the purchase of tractors, trailers, tires and fuel and a once a year tax called a heavy vehicle use tax.

For example, a trucker purchasing a $75,000 tractor and a $16,000 trailer and operating them 100,000 miles a year at six miles per gallon of fuel will pay federal excise taxes, in the year of purchase, at the following rates and in the following amounts:

Taxable Item	Rate	Amount
Tractor	12% of retail	$9,000
Trailer	12% of retail	1,920
Tires	$10.50 plus 50 cents per pound over 90 pounds	369
Diesel Fuel	15¢ per gallon	2,500
Use Tax	$550 per year	550
	Total	$14,339

It is generally thought that the excise taxes that truckers and other full paying highway users pay are user fees -- fees paid for the use of the highways with the money paid going back into the highways. In practice, the full paying highway user pays for much more than highways. He pays the share of those who are partially or totally exempt from highway taxes ($1.1 billion per year). He pays for mass transit ($1.2 billion per year). He pays enough to fund social and economic policy initiatives that have become attached to the highway program ($.5 billion per year).

Alliance for Simple, Equitable & Rational Truck Taxation
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Now, it is proposed that the excise taxes paid by highway users no longer be deductibile and that the revenue accruing to the government as a result of eliminating deductibility accrue to the general fund -- in other words, used for everything but highways.

As applied to trucking companies and other full paying highway users, the elimination of the deductibility of excise taxes is patently unfair. It constitutes a form of diversion in that it effectively increases highway user taxes and earmarks the revenue for purposes other than highways. It singles out for added tax burdens one of the few industries that has, through user fees, paid more than its way. It leaves unburdened that industry's main competitors -- railroads -- who, through the receipt of general revenue subsidies, have helped create the need for added revenue.

Not quite two years ago, the Senate Finance Committee had before it a bill, S.1739, that would increase the excise tax of users of ports and inland waterways. Hearings were held and Senator Packwood made the following statement to the proponents of increasing user fees:

> Senator Packwood. Suddenly the barge (user) fees go up by twice, and the cost of shipping by barge goes up 10, or 20, or 30 percent and you are the rail company, the only other form of transportation. So you raise your rates by 7, or 8, or 9 percent, if the barges go up 10 percent, or 19 percent if they go up 22 percent. You stay under them. You can undercut them, and yet from the standpoint of the farmer who is trying to ship wheat or any other farmer who is trying to ship some kind of produce, they are going to be stuck with higher and higher fees, even though those may not be cost related fees any longer as far as the railroad is concerned. They are competitively related but not cost related. Hearings, June 5, 1984, page 244.

We hope the Chairman would recognize that similar forces are at work here. Much of the trucking industry competes with much of the rail industry. Many truckers compete with railroads that have received direct general revenue subsidies. Some truckers compete with Conrail which has had $7 billion given to it and which is presently exempt from all state taxation. Increasing the trucking industry's excise taxes by eliminating their deductibility distorts the competitive balance between rail and truck and works to the disadvantage of shippers who have been able to depend on both rail and truck services.

We recognize that the Committee is going to have to raise new revenue. We submit that new revenue should be raised from as broad a base as possible. After all, deficit reduction is not a trucking industry problem, it's an American problem.

We note that in the search for a broad based tax some discussion has been given to an increase in the gas tax. In our opinion, the proposals that have surfaced in this area are flawed because they tax only the fuel consumed by highway users.

We suggest to the Committee that if a fuel tax is to be considered, the fuel of all transportation modes should be taxed. Based on fuel consumption data compiled by the Department of Energy, we have calculated that a tax of 7.4 cents per gallon, applied to all transportation modes, would produce $12.4 billion per year or $62 billion over five years -- the amount of new revenue originally thought necessary to finance tax reform.

We appreciate the consideration of our views.

Respectfully submitted,

Thomas A. Callaghan Jr.

Thomas A. Callaghan, Jr.
Executive Director

STATEMENT
of the

AMERICAN FISHING TACKLE MANUFACTURERS ASSOCIATION

before

THE SENATE FINANCE COMMITTEE
IN OPPOSITION TO THE REMOVAL OF THE DEDUCTIBILITY OF EXCISE TAXES

April 21, 1986

The American Fishing Tackle Manufacturers Association (AFTMA) is composed of over 500 member companies which collectively supply over 95% of all the fishing tackle and related accessories sold in the United States. AFTMA has been actively involved in the preservation and enhancement of the nation's fishery resource since its inception in 1933. In 1949, it established the Sport Fishing Institute in Washington, D.C., to provide scientific and resource management advice to the Department of Interior. It supported the original enactment of the Federal Aid in Sport Fish Restoration Act of August 9, 1950. Since then, it has been actively involved in the enhancement and management of all the nation's aquatic resources.

AFTMA is opposed to Senator Packwood's proposal to remove the deductibility of excise taxes. AFTMA members now pay some $54,000,000 of excise taxes (commonly referred to as Dingell/Johnson, Wallop/Breaux and Sport Fish Restoration tax) which they deduct as reasonable and ordinary business expenses. To treat those costs as income is unfair, inconsistent with national resource policy, regressive and disruptive.

BACKGROUND

The Federal Aid in Sport Fish Restoration Act as subsequently amended provides for the imposition of an excise tax of 10% on all fishing tackle sold in the United States. The funds collected along with excise taxes on outboard motors, fish finding gear and motor boat fuel are deposited in a dedicated fund. Funds collected from the sale of tackle are distributed to the states by means of a formula grant for the purpose of enhancing recreational fishing. The excise tax is paid directly by the domestic manufacture and in the case of imported goods by the importer. These taxes are paid at the time the goods are sold and are not deferrable until receipt of any portion of the tax passed on is received.

ALL AMERICANS RECEIVE BENEFITS FROM THE EXCISE TAX

Although the funds are directed at the restoration and management of fish resources, there is considerable additional value received by the public at large in the form of environmental enhancement, aesthetics and increased real estate values. Many of the projects funded with this money provide the American public with greater access to the aquatic environment and have resulted increases in associated real estate. In addition, healthy aquatic environments allow for the natural cleansing of the water and increase everyone's enjoyment of it. The Packwood proposal place 100% of the burden for these benefits on the tackle manufacturer or the tackle user through the payment directly or otherwise of the excise tax.

THE PROPOSAL IS INCONSISTENT WITH FEDERAL RESOURCE MANAGEMENT POLICY

This proposal will not increase the revenues available to the state or federal government to improve management or restoration of the resource. Instead, it will shift the entire burden of the funds projects to only one portion of the users of the aquatic environmental, the angler. This shift is extremely unfair in light of the federally sponsored and universally recognized concept of multiple use now being factored into all federal and state water projects. AFTMA is not opposed to the concept of privately supported resource enhancement, but the burden ought to be equally shared by the user groups that are getting the benefit.

NONDEDUCTIBILITY WILL PLACE SECTORS OF THE AMERICAN INDUSTRY AT A COMPETITIVE DISADVANTAGE

As this excise tax is applied, importers of fishing tackle have a built-in advantage in practical terms in the payment of the tax. The imported goods generally have a lower value than comparable domestically produced goods and, therefore, the tax burden is less. This is already a highly import sensitive industry with sectors of the industry experiencing as high as 90% import penetration. Giving imports yet another competitive advantage will further enhance the decline of the domestic industry.

THE PROPOSAL IS REGRESSIVE

Various sectors of the tackle industry will be able to pass the increased cost of the nondeductibility of the tax onto the consumer. NPD Special Industry Services in its report on Sport Fishing Participation in 1984, concluded that the typical customer was a male, age 35 to 54, with income under $15,000. It also indicated the individual was more likely to be a citizen of a southern state. The 1980 Fish and Wildlife survey indicates that income levels of fishermen are roughly comparable to income levels of Americans generally with over 42 million people enjoying the sport in 1980. Thirty percent of the populations of small towns and rural America fish. Thirty-two percent of all fishermen in the U.S. had combined household incomes of less than $15,000. Present federal and state management strategies recognize that these are the fishermen most likely to use the resource for subsistence reasons. To the extent that the excise tax will be passed on, it will result in a substantial increase in the effective tax burden on these Americans. The very same people the tax reform effort is support to benefit.

CONCLUSION

The present status of allowing for a business deduction for the payment of the Sport Restoration tax is both fair to the American public, the angler and the U.S. industry and is an appropriate allocation of the tax burden.

News Release

American Heart Association
National Center
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For Release: PMs, April 21, 1986

PANR 86-0005
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Scott Ballin
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HIKE TAXES ON CIGARETTES, AHA URGES LAWMAKERS

WASHINGTON, April 21--The American Heart Association today asked the Senate Committee on Finance to "act in the public's health interest and also show fiscal responsibility" by increasing excise taxes on cigarettes from 16 cents to 32 cents per pack.

The AHA, acting as a member of the Coalition on Smoking OR Health, also asked lawmakers not to allow tobacco companies to deduct excise taxes as a business expense.

"Cigarettes should be treated differently than consumer products like fishing rods and tires; these products don't kill people, cigarettes do," said AHA spokesman Scott Ballin.

Increased excise taxes on cigarettes will not only raise revenue, but also discourage smoking among teenagers because of higher prices.

Quoting Dr. Kenneth E. Warner of the University of Michigan School of Public Health, Ballin said that a ten percent increase in cigarette prices would generate a 14 percent decrease in the number of cigarettes smoked by teenagers and also result in a 12 percent decrease in the number of teenage smokers.

Increasing cigarette taxes not only makes good fiscal sense, but also demonstrates Congress' concern for public health, Ballin said.

=more=

excise tax/add one

Cigarette smoking claims an estimated 170,000 lives each year as a result of heart disease.

The AHA Board of Directors recently approved a public policy statement urging the federal government to increase the cigarette excise tax from 16 cents to 32 cents a pack, with the tax indexed to inflation for future years. The statement also encouraged states to increase cigarette taxes, particularly those states which currently tax cigarettes below the national norm.

"Indexing the excise tax on cigarettes, both to the price of cigarettes and to the consumer price index, helps to maintain the real value of the tax," Ballin said.

The government lost a significant amount of revenue for 30 years because the excise tax on cigarettes stayed at eight cents from 1951 to 1982. It now stands at 16 cents per pack, but it is not indexed to the price of cigarettes, nor to the consumer price index, and again the government stands to lose money in the future, according to Ballin.

=30=

asap

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Advisory Committee

George Gallup, Jr.
Pollster
Honorary Chairman

Pat Boone
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Joseph A. Califano, Jr.
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Hon. Herman E. Talmadge
Former U.S. Senator

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Commissioner, L.A. County
Commission on Alcoholism

Michael E. De Bakey, M.D.
Heart Specialist

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Ernest P. Noble, Ph.D., M.D.
Director, Alcohol Research, UCLA

Sue Rusche
Director, Families in Action

Jokichi Takamine, M.D.
Chairman, AMA Committee
on Alcoholism

Rev. David A. Works
President, North Conway Institute

Harley M. Dirks
Treasurer

STATEMENT OF

THE AMERICANS FOR SUBSTANCE ABUSE PREVENTION

PRESENTED TO

THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

CONCERNING

FEDERAL EXCISE TAXES ON ALCOHOL

ON

APRIL 21, 1986

Mr. Chairman and Members of the committee, in 1951, federal excise taxes on all alcoholic beverages were raised to help finance the Korean War effort. Taxes on distilled spirits were increased in 1985 -- 34 years later -- but the excise taxes on beer and wine remain unchanged.

The Americans for Substance Abuse Prevention (ASAP), believe it is time to equalize taxes on all alcoholic beverages to finance another war. The war on alcohol and drug abuse in America.

The present need to generate additional funds for alcohol and drug abuse and other health-related programs is particularly acute. The enactment of the Balanced Budget and Emergency Deficit Control Act of 1985 is expected to result in substantial cutbacks in appropriations for national health programs, including Medicare and the National Institute on Alcohol Abuse and Alcoholism (NIAAA).

Former NIAAA Director Dr. Robert Niven says the budget cuts would be "potentially devastating" to NIAAA and the National Institute on Drug Abuse (NIDA).

To offset the effects of such cutbacks, the Americans for Substance Abuse Prevention supports a tax increase on beer and wine as a means of maintaining adequate funding levels for NIAAA, state block grants, alcohol prevention programs in the schools, alcoholism and drug abuse treatment and other health care programs, such as Medicare and Medicaid.

The simplest way to increase taxes on beer and wine would be to equalize the tax rates for all alcoholic beverages. Adjusted for alcohol content, beer is currently taxed at one-fourth the rate of distilled spirits, and wine is taxed at one one-seventeenth the rate. The current federal excise tax equates to less than three cents on a can of beer and less than a penny on a glass of wine.

Meanwhile, the tax on distilled spirits was increased 19 percent in October 1985.

The National Alcohol Tax Coalition estimates that an increase in federal excise taxes could generate additional revenues of between $4.3 billion and $20.5 billion annually. Currently, $5.4 billion is generated in federal alcohol taxes, or less than one percent of all federal revenues. In 1951, when beer and wine taxes were last raised, alcohol taxes accounted for approximately five percent of all federal revenues.

Increased alcohol taxes would, of course, be user taxes, and would have no impact whatsoever on the estimated 36 percent of the population that abstains from alcohol use. Also, it would have a minimal effect on light and moderate drinkers. The U.S. Department of Health and Human Services estimates that 10 percent of all drinkers account for 50 percent of the alcohol consumed in the United States.

The majority of Americans favor increasing the tax on alcoholic beverages. More than half of the people surveyed in a 1983 Gallup Poll said they favored doubling the federal tax on alcoholic beverages. Many prominent organizations, including the American Association of Retired Persons, the National Council on Alcoholism, the American College of Preventive Medicine, and the Center for Science in the Public Interest support the tax increases.

Also, several dozen leading economists, including Stanford's Victor Fuchs and Princeton's Alan Blinder, have petitioned Congress to increase federal excise tax on alcoholic beverages. They "believe that the public health costs and other external costs associated with the consumption of alcoholic beverages are so significant as to justify substantial excise taxes on those beverages."

Alcohol abuse in America costs the nation more than $120 billion annually -- approximately 25 times the amount generated in excise taxes -- and accounts for about 10 percent of the nation's death toll. And alcohol consumption is rising. Per capita consumption rose approximately one-third from 1960 to 1982, with beer and wine leading the way. Advertising expenditures for alcoholic beverages have increased to approximately $1 billion a year, including more than $500 million by the beer industry alone.

Duke University researchers estimate that if alcohol taxes doubled and then equalized, consumption of alcoholic beverages could be expected to drop by approximately 14 percent.

The Americans for Substance Abuse Prevention joins with other organizations in urging an increase in beer and wine taxes and earmarking the revenue for:

-- Alcohol research

-- Prevention

-- Treatment

-- And support of health care programs such as Medicare and Medicaid and publicly funded agencies such as NIAAA, NIDA and the National Institute on Mental Health.

Thank you for the opportunity to present our views.

STATEMENT
OF THE
AMERICAN SOCIETY OF INTERNAL MEDICINE
FOR THE RECORD OF THE SENATE FINANCE COMMITTEE HEARING
ON
EXCISE TAXES

April 21, 1986

The American Society of Internal Medicine (ASIM) strongly supports the proposal being considered by the Committee to adjust excise tax rates to reflect price increases. In addition the Society supports the proposed prohibition of tax deductions for excise taxes paid by cigarette manufacturers and alcoholic beverage producers.

ASIM is a national medical organization consisting of physicians who are recognized as specialists in internal medicine. The Society is concerned with social, economic and political issues that bear on the ability of internists to provide high-quality patient care.

ASIM supports disincentives for individuals to lead unhealthy life styles. The Society is on record as favoring a doubling of the excises on both alcohol and tobacco. In addition, ASIM has endorsed Senator Bradley's bill, S. 1950, which would disallow the deduction for advertising expenses for tobacco products. These proposals, as well as those being considered by the Committee—in that they would lead to higher consumer prices for substances which are hazardous to health—would accomplish this.

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As a majority of ASIM members are directly involved in the care of adult patients, the organization is all too aware of the undeniable adverse health effects of smoking. There is no doubt that smoking is the single most preventable cause of death in the United States. Associated with smoking of cigarettes is 30 percent of all cancer in this country and fully 85 percent of all lung cancers. Cigarette smoking is also a major cause of coronary heart disease and chronic obstructive pulmonary disease. It is associated with approximately 30 percent of the deaths of the one-half million Americans who die of coronary heart disease each year.

Significantly, smoking related disease and lost productivity cost a total of $65 billion annually according to a recently issued report of the Office of Technology Assessment. Costs associated with the Medicare and Medicaid programs alone total $3.8 billion each year.

Increasing the cost of cigarette smoking will have a significant deterrent effect on young adults who may be on the verge of acquiring a life-long habit, according to Dr. Kenneth Warner in a report published last year by the Harvard University Institute for the Study of Smoking Behavior and Policy. Increasing the cigarette excise tax to 32 cents, as ASIM has recommended, would deter more than 800,000 teenagers from smoking, and a total of 3.5 million Americans would forego the habit.

ASIM also supports higher excise tax rates for alcoholic beverages and elimination of the deductibility of excise tax payments made by alcoholic beverage producers. In view of the large body of evidence that individuals who abuse alcohol and tobacco generate higher health care costs--thus increasing federal outlays for health programs such as Medicare and Medicaid--ASIM believes that it is reasonable to expect these individuals to contribute a greater share to support such programs.

ASIM supports a releated measure--the elimination of federal subsidies for the growing of tobacco.

The Society is concerned that federal health programs are being subjected to a disproportionate share of budget cuts that are likely to result in an eroding of the quality and availability of care provided to patients. ASIM welcomes proposals that raise needed revenues while enhancing the health of Americans by discouraging them from engaging in unhealthy practices.

ASIM looks forward to the inclusion of the provisions to increase tobacco and alcohol excise taxes and to prohibit tax deductions for the payment of such taxes by the respective industries in the Committee's tax reform proposal. The Society would be pleased to assist the Committee further in its consideration of these proposals.

/dmm
G-RT-0431

STATEMENT OF
THE AUTOMOBILE IMPORTERS OF AMERICA, INC.
BEFORE THE
SENATE FINANCE COMMITTEE
APRIL 21, 1986

The Automobile Importers of America ("AIA"), an association of automobile importers in the United States, includes 11 European, 8 Japanese, and 1 South Korean company. (a list of members is attached)

AIA is particularly concerned about two aspects of the Chairman's tax proposals: (a) the proposed elimination of the tax deductibility of excise taxes and tariffs; and (b) the proposed linking of transfer price for tax purposes to value for customs purposes.

AIA has a vital interest in the tariff deductibility issue, since this is an integral part of tax and business planning by its members. Similarly, tax and customs transfer pricing plays a fundamental role in the day-to-day business of AIA members.

A. AIA Opposes Eliminating the Tax Deductibility of Tariffs

Currently, tariffs paid by importers are deductible against gross income as ordinary and necessary business expenses. The deduction reflects the long-established U.S. policy of taxing net income after deducting amounts spent to earn the income, as opposed to taxing gross income. This policy has been an integral part of federal income taxation since the initial imposition of the federal income tax following the ratification of the Sixteenth Amendment in 1913.

Simply put, AIA opposes eliminating the tax deductibility of tariffs because elimination would cost too much. U.S. consumers and domestic automobile manufacturers would pay the more easily quantifiable cost of increased car prices, which could be substantial. A less easily quantifiable cost would be reflected in damage to the world economy and to the U.S. role as a leader in promoting an open trading system. Elimination of the deduction also would raise constitutional questions.

The Costs of Eliminating the Tax Deductibility of Tariffs Would Be Far Reaching

The Chairman's tax proposal would establish a maximum corporate tax rate of 35%. At this rate, each $1.00 of tariff paid presently enjoys a $.35 reduction in tax, because it reduces taxable income by $1.00. Accordingly, the after-tax cost of each $1.00 of tariff paid is only $.65. If the deduction is eliminated, the after-tax cost of each $1.00 of tariff paid would be $1.00, an increase of about 54% over $.65. In effect, then, eliminating the deduction would increase all tariffs by about 54%, under a 35% corporate tax.

The following chart, with certain hypothetical figures, shows how eliminating the deductibility of tariffs would result in an increase to consumers of $140 in the price of a car whose import price is $10,000.

HYPOTHETICAL TAX ANALYSIS OF PROPOSAL'S IMPACT AS RELATED TO AUTOMOBILES

	Current	Proposal	Price Increase To Yield Current Profit Level
Cost to Importer	10,000	10,000	
Tariff (26%)	260	Nondeductible	
Ocean Freight	200	200	
Other Import Costs	100	100	
Landed Cost	10,560	10,300	
Wholesale Price to Retailer	12,000	12,000	12,000 + 140 = 12,140
Less Landed Cost	(10,560)	(10,300)	(10,300)
Gross Profit	1,440	1,700	1,840
Overhead and Other Expenses	440	440	440
Pre-Tax Profit	1,000	1,260	1,400
Federal Income Tax	350[1]	441[2]	490[4]
After Tax Profit	650	819	910
After Tariff Profit	650	559[3]	650[5]

1/ Assume 35% rate; 35% of 1,000.

2/ Assume 35% rate and nondeductibility of tariff; 35% of 1,260.

3/ 819 after tax profit minus 260 tariff not otherwise deducted.

4/ Assume 35% rate and nondeductibility of tariff; 35% of 1400.

5/ 910 after tax profit minus 260 tariff not otherwise deducted.

1. Consumers. Loss of a tax deduction results in increased taxes, which ultimately are likely to be paid by consumers. In the case of imported automobiles, for example, the aggregate lost deduction equals the import duty, 2.6%, times the average customs value of the imported automobiles, times the number of imported automobiles sold, or $697 million per year. At the proposed 35% top corporate tax rate, this lost deduction means a tax increase of approximately $244 million. For all motor vehicles and motor vehicle parts, the additional tax would be $630 million. Furthermore, because the cost of imported cars will increase, domestic producers are likely to increase their prices as they have done as a result of the VRA and recent changes in the exchange rates. Therefore, at a time of record profits for Detroit, they will get yet another free ride. Since imports represent only a fraction of the market, the ultimate cost to consumers, therefore, could approach $1 billion annually.

With respect to light trucks, the already onerous 25% import duty produces a total tariff cost of $901 million. The non-deductibility proposal would increase this cost to $1.22 million, assuming a 35% corporate tax rate.

This tax increase likely would be passed along to consumers in the form of higher automobile prices. Moreover, these higher automobile costs would fall heaviest on low-income Americans least able to afford them. According to an independent analysis conducted by deSeve Economics Associates, households with incomes of less than $20,000 would pay 23% of excise and tariff increases but account for only 12% of all income. Households with incomes above $100,000, on the other hand, would account for 14% of all income, but would pay only 6% of excise and tariff increases.

2. World economy. A 54% increase in effective U.S. tariff rates quite likely would provoke other countries to raise their tariff rates directly or indirectly. Many of our trading partners have corporate tax rates above 35%. In many countries therefore, the effective tariff increase could be more than 54%. In a country with a 46% corporate rate, for example, tariffs would effectively increase by 85% if a mirror image proposal were adopted. The victim would be the world economy, and with it, U.S. exporters.

The Proposal Is Inconsistent With The GATT

Although it is unclear whether the elimination of the tax deductibility of tariffs is a technical violation of the GATT, it certainly is a violation of the spirit of the GATT, and of other international agreements aimed at decreasing tariffs. As a major supporter of the GATT and of international efforts to reduce trade barriers, the United States would lose much credibility and would jeopardize future GATT rounds by itself increasing the effective rate of its tariffs.

More important, GATT-inconsistent actions by the United States are likely to jeopardize U.S. efforts to render international trade "GATTable", and jeopardize chances for a successful new round of multilateral trade negotiations. In short, implementation of this proposal would put the United States in the incongruous position of creating a major trade barrier on the eve of trade liberalizing efforts.

Constitutionality

The Sixteenth Amendment authorizes a tax on income. Courts have interpreted this as authorizing only a tax on net, as distinguished from gross, income. Net income means income net of those expenses required to earn the income. Because tariffs are clearly expenses incurred in earning income, disallowing them as deductions would appear to fly in the face of constitutional authority.

B. AIA Urges Separate Hearings On Transfer Pricing

Price for tax purposes and value for customs purposes result from wholly different computations entered into for different reasons. Value is more important for customs purposes than price is for tax purposes, because duty is levied on value. Income tax, on the other hand is levied on taxable income, not price. This issue is an extremely complex one and more study needs to be given to the effect, if any, of linking these two disparate concepts.

AIA urges the Finance Committee to hold separate hearings on the proposal to link price for tax purposes to value for customs purposes.

Conclusion

As a way of raising revenue, elimination of the deductibility of tariffs imposes a high cost on American consumers, businesses, and manufacturers, including U.S. exporters. It is also likely to jeopardize U.S. efforts to move toward a more open international trading system. The proposal should be dropped.

Separate hearings should be held on the transfer pricing issue in order to further refine its purpose and to determine its likely effects.

LIST OF AIA MEMBERS

ALFA ROMEO

BMW

FIAT

HONDA

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SUBARU

SUZUKI

TOYOTA

VOLVO

Baruch College
The City University of New York
17 Lexington Avenue
New York
N.Y. 10010

DT: 1 May 1986

TO: Senate Finance Committee

FR: Professor J. J. Boddewyn
Bauch College, City University of New York

I would like to draw the attention of your Committee to some of the negative implications of the Packwood plan for tax reform -- particularly, the proposed increase in various excise taxes and non-deductibility of excise taxes and import duties (tariffs). I am focusing on the April 21 statement of J. Roger Mentz (Assistant Secretary, Department of the Treasury) before your Committee because it provides some cautions endorsement by the Administration of these proposals, together with various data and arguments in their favor.

In brief, Mr. Mentz acknowledges that the Packwood proposals are likely to impact business firms and consumers unfavorable. Nevertheless, he justifies them on the grounds that, in some cases, the proposed tax increases apply to goods that create social costs insufficiently recovered by society -- besides being needed to offset other federal revenue losses generated by the Packwood plan.

In response, I would like to emphasize that: 1) business and consumer losses are not going to be minor; 2) the "social cost" argument is a weakened, controversial one, and 3) other undesirable developments are likely to follow from the implementation of the Packwood proposals.

Business And Consumer Losses Are Going To Be Significant

In brief, under the Packwood proposals, either consumers will pay more for most of the goods and services they buy, or business firms will earn less (something will reduce federal income tax revenues), or fewer goods and services will be made -- with some loss of employment in the latter two cases -- or some mixture of all three unfavorable impacts will take place.

Consumers

Consider the following increases: 1) the federal tax on airline tickets would increase by half, from 8 to 12 percent; 2) gasoline would cost 4 to 5 cents more per gallon; 3) the federal tax on telephone bills (now at 3 percent) would go up by about one half; 4) a fifth of liquor would cost an extra dollar, and 5) the price of a pack of cigarettes would increase by 9 cents (not counting state and city taxes). These are some of the direct hikes that would be imposed on consumer prices, but many business price increases (see below) will affect them indirectly and just as badly.

Besides, numerous imported goods already pay sizeable import duties (for example in the 19.8 to 31.4 percent range for textile fibers and apparel goods). Not allowing their tax-deductibility, as proposed by Senator Packwood, is bound to increase their prices to consumers (see below).

With inflation now in the 3 to 5 percent range, these two types of increases -- and there are others (see below) -- are not minor ones.

Business Firms

Among other contemplated increases, the excise tax on diesel fuel would rise from 15 to 23 cents per dollar, while the excise tax on heavy trucks would jump from 12 to 18 percent of their retail purchase price. The already mentioned hikes in telephone and gasoline excise taxes would also be incurred by business.

Besides, the Packwood plan would no longer allow firms to tax-deduct the excise taxes and import duties they pay on many products used in production. Such payments to the federal government have always been treated as regular production costs -- just like salaries, rentals, property taxes, raw materials, freight and electricity bills -- and been deducted as ordinary and necessary business expenses when computing taxable income. After all, these government charges represent just another cost of doing business; and they are unavoidable since firms cannot automate or robotize taxes. Therefore, there is no fundamental logic for proposing that excise taxes and import duties be no longer tax-deductible.

In his statement, Mr. Mentz argues in fact that the government can alter this logic and the tradition of tax-deductibility although acknowledging that increasing excise taxes and eliminating the non-deductibility of excise taxes and tariffs is very likely to hurt business firms and consumers.

When business incurs higher costs, it practically always increases prices -- especially when other firms are similarly affected, as would be the case under the Packwood proposals, since they all use telephones, air transportation, trucks or freight, either directly or indirectly, in one way or another.

In his statement, Mr. Mentz estimates that for every dollar of additional excise tax or tariff -- in the forms of increases or nondeductibility -- there would be an additional 35 to 54 cents of costs to recover through price increases (assuming a 35 percent maximum tax bracket). The impact will vary from industry to industry and from firm to firm, but it is safe to assume that practically all companies bear the burden of some excise taxes and use some imported foods, directly or indirectly; and that a large majority of these firms can and will pass on increased costs down the line, all the way to the final customers.

Notice, as Mr. Mentz himself points out, that both the increases in excise taxes and the non-deductibility of excise taxes and import duties impact companies in proportion to the volume of business generated but not in proportion to the profits earned, as in the case of income taxes. In other words, business taxes would increase in parallel with how much business takes place rather than with how much profit is earned, thereby discouraging greater economic activity if prices cannot be proportionately increased to cover additional tax-related costs.

Consequently, Mr. Mentz recognizes that the Packwood proposals "would increase the costs and prices of a wide range of domestically produced goods" -- with a likely negative impact on production, employment, profits and income taxes collected by the federal government.

The Taxpayers

The Packwood plan is built on the principle that the proposed tax reform should be revenue neutral. If, for example, the maximum tax bracket for individuals is going to decrease from 50 to 35 percent, then revenues must be raised somewhere else.

In this context, Senator Packwood is really proposing to take away from taxpayers through his excise and tariff proposals part of what he would give them through income-tax decreases. This is either a futile exercise in tax reform or a deceptive trick played on U.S. citizens. Why not instead, limit the decrease in income-tax brackets and leave excise taxes and tariff expenses alone if something has to give? At least, this would not eliminate the current logic and tradition of allowing all taxes to be tax-deductible; and it would not precipitate price increases and greater inflation which are certainly not needed in terms of sound economic growth and improved U.S. international competitiveness, just when a weaker dollar is helping us!

However, even if some trade-off among taxes is desirable, we must realize that increases in excise taxes and the non-deductibility of excise taxes and tariffs will amount to an increase in regressive taxation. Since most goods would be affected directly and indirectly, the resulting price increases are bound to affect practically everybody but particularly lower-income people. Assuredly, many of the basic goods which everybody buys but on which lower-income people spend most of their money will go up in price so that Senator Packwood is really proposing a "class tax" on the less-well-to-do. Since their incomes are low, they will not save that much on income taxes, while they will have to spend more on the goods and services they regularly buy -- as various studies by the Citizens for Tax Justice have amply established. Therefore, the Packwood plan is readily open to charges of favoring better-to-do people.

The "External Social Costs" Argument Is Weak

The major justification advanced by Mr. Mentz is that excise taxes are mainly applied to goods (liquor, cigarettes, transportation, etc.) which may generate more costs than benefits for society so that taxing them more -- directly and indirectly -- will help society recover more of these "social costs." Alternatively, people will either use fewer of these goods if their prices go up, or accept to pay more to keep using them.

I lack space here to discuss this point at sufficient length but "social costs" is a slippery concept difficult to operationalize and measure, and therefore conducive to contradictory conclusions as to how large they truly are and as to how large taxes should be to recover them.

Lacking sufficient or convincing evidence on this issue, it is tempting to say: "Why not increase the tax burden on alcohol, cigarettes, gasoline and imports?" -- all controversial items that have repeatedly been singled out for tax increases in the past. However, does such a simplistic and hoary tax expedient deserve to be called "tax reform?" Besides, does it warrant abandoning the logic and tradition of tax-deductibility of excise taxes and tariffs? Moreover, if people are going to use fewer of the products affected by the Packwood proposals, employment and profits in these industries will be affected unfavorably. On the other hand, if people keep using these products although their prices went up on account of the Packwood increases, they will have less to spend on the products of other industries whose employment and profits will be negatively impacted. In other words, someone else's ox or cash cow will be gored.

Other Undesirable Implications Of The Packwood Plan

Mr. Mentz acknowledges that numerous U.S. tax treaties with foreign countries would be adversely affected, and so would U.S. obligations under the General Agreement of Tariffs and Trade (GATT) which we co-signed with some 90 countries. GATT obligations would require that we reduce some of our import duties in order to compensate for the loss of exports by other countries since the Packwood-proposed non-tax-deductibility of tariffs paid on imported goods would probably result in a decline in U.S. imports. If we do not reduce our tariffs, foreign countries are allowed to retaliate and thus reduce U.S. exports as well as the income and employment generated by U.S. exporters.

Second, Senator Packwood's proposals about excise taxes and tariffs really amount to developing a system of federal consumption taxes. Excise taxes are pretty much like sales taxes, except that we do not notice them much since they are buried in the retail prices of the products we buy. There have been several proposals to introduce a federal sales tax or a value-added tax. Such consumption-tax proposals have been strongly opposed by many Senators, organizations and people. However, the same effect would be largely achieved through the Packwood plan -- except that, instead of being introduced through the "front door" where they are likely to vetoed, they would be slipped in through the "factory door." Those Senators opposed to federal consumption taxes should oppose Senator Packwood's proposals for that very reason.

Finally, there is every reason to anticipate that increases in excise taxes and the non-deductibility of excise taxes and tariffs would soon be duplicated and even triplicated by state and local governments if they are adopted by Congress. Therefore, a second round of consumer price increases, inflationary pressures, unemployment losses, decrease in U.S. international competitiveness, etc. would almost certainly follow these questionable forms of federal "tax reform."

BAY
BEVERAGE
DISTRIBUTORS

April 29, 1986

The Honorable Bob Packwood
U.S. Senate
Committee on Finance
Room SD 219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

Please find attached my statement which I wish entered into the record pursuant to the hearing being held in May on the non-deductibility of federal excise taxes.

I thank you in advance for your most kind attention to my opinion.

Sincerely yours,

Edwin L. Bealer
Vice President/Principal

ELB:ldb

Attachment

2949 BEST FRIEND ROAD, CHARLESTON, SC 29418 (803) 747-1475
2310 RIBAUT ROAD, PORT ROYAL, SC 29935 (803) 524-6833

The following is a statement from Edwin L. Bealer, Vice President and Principal of Bay Beverage Distributors, Inc., and Bay Beverage Distributors of Beaufort, Inc., both corporations being wholesale beer distributorships in the state of South Carolina, in Charleston and Beaufort respectively. It might further be noted that Mr. Bealer serves on the board of directors of the South Carolina Beer Association and, in addition, represents the state of South Carolina on the board of directors of the National Beer Wholesalers Association.

***

For slightly over 18 years, I have been proud to be actively involved in the distribution of malt beverages in two states, representing the products of three major domestic brewers and numerous other smaller brewers and importers. During this time I have been pleased to note that my industry has, on the one hand, reacted in a responsive and conscientious manner to various social and environmental problems related to the public's consumption of our product. On the other hand, I have also seen our industry come under siege from environmentalists, neo-prohibitionists, social reformers, and those persons who, for whatever various reasons, would have us shoulder the burden of additional taxes...a burden, I might add, that falls on the shoulders of a beleaguered industry that already pays a disproportionate share of taxes.

Senator Packwood, in a well-intentioned effort to reduce our national deficit through tax reform, is considering as an element of this reform package a proposal that would no longer allow corporations to deduct Federal Excise Tax payments from corporate income taxes. I respectfully submit to this hearing my contention that, despite its good intentions, this proposal if enacted would be discriminatory, regressive, and contrary to the stated intent of tax reform.

While I am sure my case will be argured by those far more articulate and eloquent than I, I would ask that the committee consider a few of the more major negatives surrounding this proposal.

Senator Packwood claims that his tax proposal would give working men and women a tax break. Nothing could be further from the truth. In fact, this proposal is a hidden tax because the nation's brewers will have to raise prices on a 6-pack of beer an estimated 25¢ - 30¢ in order to attempt to offset the damage this proposal would inflict upon this industry's "bottom line". In the end analysis, corporations do not pay taxes...only people pay taxes. In the case of this proposal, the people who would pay this tax are those who can least afford it. Four out of five beers are consumed by families earning less than $30,000.00 annually.

Senator Packwood's proposal is regressive. Increased prices can lead to decreased tax revenue. In my state of South Carolina, we as distributors, currently pay the highest state excise tax in the country. In fact, our state excise taxes on beer and wine make us the third largest contributor to the state's general fund followed only by corporate and personal income taxes. The non-deductibility of excise taxes threatens the billions of dollars already paid in federal and state taxes. American consumers now pay more for tax on beer than for the ingredients and labor combined.

Senator Packwood's proposal threatens, through reduced sales, a portion of the 189,500 direct jobs in the U.S. brewing industry. As an example, a 4% loss in beer sales could wipe out 3200 jobs in the brewing industry and another 2,000 in related fields, such as agriculture, can and glass manufacturing and packaging. Further, a 4% sales loss translates into almost 100 million cases of beer and the resulting federal and state taxes which they represent.

My message to the committee is simple..."ENOUGH IS ENOUGH". I am tired of my industry being a whipping boy for every politian who professes to have found a panacea for the reduction of our budget deficit. I vigorously oppose both the non-deductibility issue, as well as, any increases in the federal excise tax.

Thank you.

STATEMENT OF BELLSOUTH CORPORATION ON THE EXCISE TAX HEARINGS OF THE U.S. SENATE COMMITTEE ON FINANCE,
APRIL 21, 1986

BellSouth Corporation ("BellSouth") welcomes the opportunity to file with the Finance Committee this statement for the record setting forth our views on the excise tax proposal of the Senate Finance Committee Tax Reform Markup Document.

BellSouth is one of seven regional holding companies formed as a result of the divestiture of the American Telephone and Telegraph Company. It is the largest of the regional companies with $25 billion in assets and approximately 92,000 employees. Through its two telephone operating companies, Southern Bell Telephone & Telegraph Company and South Central Bell Telephone Company, BellSouth furnishes local and exchange access communication services to 14.5 million residence and business customers in nine southeastern states.

Last year, BellSouth collected federal excise taxes of $145 million on behalf of the government. Currently, telephone companies merely act as agent in collecting these taxes from customers. The tax is not imposed on the provider but the user of the service. Therefore, telephone companies do not include these amounts in taxable income or take a corresponding tax deduction.

This is in contrast to excise taxes imposed directly on the processing or manufacture of commodities such as gasoline, tires, tobacco and liquor. While excise taxes certainly are considered when determining retail prices, all receipts from sales are taxable income and a deduction is allowed for excise taxes paid. In any case, these industries do not serve in the same agent capacity as telephone companies.

Senator Packwood's proposal would shift the incidence of excise tax from the consumer to the telephone companies. In addition, the excise tax would be included in the gross income of the telephone company and no deduction would be allowed when the taxes were paid to the government. The effect of the proposal would be to create taxable income from the receipt of government funds when no economic gain would be realized.

Under our tax system, a receipt must represent gain to be subject to taxation. Although Congress has been empowered to collect taxes on income, the courts have held there is no constitutional authority for a gross receipts tax. Characterization of these funds as income is incompatible with traditional tax policies and appears to be an unconstitutional tax on gross receipts.

Moreover, if a purpose of tax reform is to reduce the burden on low income taxpayers, this proposal is contrary to such intent.

The undesirable, discriminatory characteristics of the telephone excise tax itself have long been recognized. When considering the Excise Tax Reduction Act of 1965, the Senate Finance Committee stated:

> The tax on local and toll telephone service and teletypewriter exchange service is undesirable as a permanent feature of our excise tax system. This conclusion was reached on the grounds . . . that these taxes are regressive and therefore fall with greater severity on those with low incomes.

It is evident that this proposal could further impede progress in accomplishing the national goal of universal telephone service for all individuals. The negative impact of the excise tax would be compounded when included in the telephone rate structure.

Regulated telephone companies are allowed rates which recover all operating costs, including taxes. If the revenue burden were imposed evenly on all customers, for each dollar of revenue from excise tax taken in as income, the effect of taxation at the proposed marginal rate of 35% would require the collection from ratepayers of $1.54.

Additionally, characterizing excise taxes as revenues could subject them to state and local taxes on gross receipts, sales and income. These additional new tax costs would raise telephone rates substantially for all consumers.

Government agencies, schools, hospitals, charitable organizations and other institutions currently exempt from the tax would see a dramatic rise in their telephone bills if these costs were reflected in the rate structure. Higher rates also would provide an additional incentive for large business customers to bypass the established network for private systems not subject to excise taxes.

In summary, BellSouth opposes the treatment of telephone excise taxes contained in the Finance Committee Markup Document. It is incomprehensible that telephone companies could be penalized for having served as collection agent for the federal government.

The excise tax originally was imposed to raise revenue during the two world wars. It always has been regarded as temporary and currently is scheduled to expire after 1987. It should be allowed to do so.

Bluff City Beer Co.

SIXTH & HENDERSON AVE
P.O. BOX 1227
POPLAR BLUFF, MISSOURI 63901
(314) 785-9442

POPLAR BLUFF
CAPE GIRARDEAU
KENNETT
BONNE TERRE
MISSOURI

April 29, 1986

Betty Scott Boom
Committee on Finance
Room S.D. 219
Dirksen Senate Office Building
Washington, DC 20510

I wish to add my voice in opposition to Senator Packwood's proposal to repeal the corporate deduction for excise taxes. Our industry is already paying over three billion dollars annually in federal and state excise taxes and we cannot afford to pass through the large price increases to our consumers these increases would demand without severly effecting our sales.

Excise taxes are regressive hidden taxes that our consumers must pay for the privilege of enjoying our products. It is our opinion they are already paying enough for the privilege.

The wholesaler-distributors in this country are carrying a very heavy tax burden. We are finding it more difficult to make long range plans to preserve our business and provide for our families and for our employees' families due to continuing change in IRS regulations and proposals fostered on us by members of Congress, in this instant, Senator Packwood.

The recent changes brought on by ERISA and TEFRA have not helped our cause. They raised taxes but failed to bring spending cuts, as promised.

The excise taxes will only add to our burden. We in the delivery business must buy tires, motor fuel, telephones, trucks and support equipment that is already subject to excise taxes.

We are paying our share to run this fine country of ours and to add additional tax burdens to our industry is not only unfair to us, but to the millions of consumers who enjoy our products.

I urge you to defeat any proposals to increase excise taxes as a way to raise money to satisfy an insatiable appetite for the taxpayers dollars.

The American voters has consistently tried to send a message to our representatives in Congress that we are tired of huge deficits brought on by the spending practices of our law makers. We have demanded that our representatives reduce federal spending by making cuts in present programs and not balance the budget by raising our taxes. Apparently, our voices are not being heard by many members of Congress.

I hope the electorate will remember to express their thoughts in the near future to those members experiencing this difficulty.

Sincerely,

Alvin H. Bess

AHB/cdm

cc: Senator John C. Danforth
Senator Tom Eagleton
Clifford R. Williams

945-5600

DISTRIBUTING COMPANY

1220 BERNARD DRIVE
BALTIMORE, MARYLAND 21223

April 23, 1986

The Honorable Bob Packwood
United States Senate Committee on Finance
Room SD 219, Dirkensen Senate Office Bldg.
Washington, D.C. 20510

Honorable Senator Packwood:

We at Bond Distributing Company would like our statement to be included in the printed record of the hearing.

We, The Bond Distributing Company, oppose the issue chaired by Oregon's Senator Bob Packwood, a tax overhaul proposal, we oppose all increased taxation on the brewing industry including back door methods that masquerade as "tax fairness" or "tax breaks." The U.S. Brewing industry means 189,500 direct jobs and billions of dollars already paid in federal and state taxes. American consumers now pay more for the tax on beer than for the ingredients and labor combined. America's 80 million beer drinkers already pay beer taxes that are three times higher than most other consumer products. It is indeed a cruel hoax to play on American consumers by offering them a tax break with one hand, then raise the prices of many consumer goods through a back door taxation method with the other.

Sincerely,
BOND DISTRIBUTING CO.

Robert J. Footlick
President

RJF/lab

BOWMAN PETROLEUM CO., INC.

PETROLEUM DISTRIBUTORS

EXECUTIVE OFFICES
P.O. BOX 489
TUNKHANNOCK, PA 18657
Phone: (717) 836-2191

P.O. BOX 311
MONTROSE, PA 18801
Phone: (717) 278-3228

April 18, 1986

Honorable John Heinz
SR-277-Russell Bldg.
1st and C Streets, N.E.
Washington, DC 20510

Dear Senator Heinz:

EXCISE TAX PROPOSAL

Please enter this letter as my statement of objection to the proposal by Senator Robert Packwood to eliminate the deduction, as a business expense, the Federal Excise tax collected by us.

This proposal would cost the American Consumer, as business would pass along the added cost. Also, I believe a trend of taxing taxes collected would be started if this proposal became law. We collect over $400,000 in Federal Excise taxes alone, for which we are not paid a commission or fee to handle the collection. Our added tax burden would be substantial.

Please vote NO on the Packwood Excise Tax proposal.

Sincerely,

Jay P. Niskey
President

cc Committee on Finance

CAWG
California Association of Winegrape Growers
926 J Street, Suite 709, Sacramento, California 95814 — (916) 441-1455

TESTIMONY OF ROBERT P. HARTZELL

TO THE SENATE FINANCE COMMITTEE

APRIL 21, 1986

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TESTIMONY OF ROBERT P. HARTZELL
TO THE SENATE FINANCE COMMITTEE
APRIL 21, 1986

My name is Robert P. Hartzell. I am President of the California Association of Winegrape Growers (CAWG) and also serve as Executive Director of the American Grape Growers Alliance for Fair Trade. The California Association of Winegrape Growers represents approximately 1,100 winegrape growers who produce about 65 percent of the non-winery owned grapes crushed for wine in California. California produces approximately 90 percent of American wine. The American Grape Growers Alliance for Fair Trade represents grape growers and several processors of grape products in the states of Washington, New York and California.

My role will be to discuss the impact the proposed wine excise tax increase would have on winegrape growers, particularly emphasizing many winegrape growers current precarious financial situation resulting from an erosion of the market for wine made from their grapes due to subsidized and/or dumped foreign wines.

I will set forth reasons why the proposed wine excise tax will be so devastating to winegrape growers.

The following demonstrates the current economic environment in which winegrape growers must operate:

1. The value of vineyards in the San Joaquin Valley of California, south of Stanaslaus Co., where 70 percent of the grapes crushed for wine in Calfornia are grown, has declined dramatically. In 1982 values were around $11,000/acre; owners are currently asking around $4,500/acre with few, if any, buyers coming forward.
2. In 1985 approximately 57,000 acres of grapes in California were abandoned or not harvested. Indications are that in 1986 the number of acres abandoned or not harvested will increase to 75,000 to 80,000 acres.
3. The price paid in California for grapes for crushing has declined precipitously. In 1981, the weighted average grower price was $246.63/ton. In 1985 the price had fallen to $160.95/ton -- a drop of $85.68/ton. Based on average yields, per-acre returns have dropped by $600/acre during the past five years.

A major factor contributing to the current economic plight of winegrape growers is the various governmental subsidies provided to winegrape growers and/or vintners by the European Economic Community (EEC), and the governments of France, Italy, West Germany and Canada.

The subsidies received by foreign winegrape growers and vintners range from government purchase of grapes that cannot be sold, to government paid distillation of surplus wine, to subsidized low interest loans, to financial incentives to remove vineyards.

These subsidies have resulted in foreign wines increasing their share of the U.S. wine market by 16 percent during the past 15 years. (13 million cases - 1970 to 59.9 million cases - 1984).

In October 1985 the International Trade Commission (ITC) found that "there is reasonable indication that some domestic producers of ordinary table wine and growers of grapes used to produce ordinary table wine are experiencing material injury."

I guess there was reasonable indication of material injury! The attached report indicates that in 1982, 45 percent of the winegrape growers surveyed were losing money. By 1984, 86 percent of those analyzed were reporting losses. I repeat 86 percent!

Given this background, the following will be some of the impact that winegrape growers and vintners will experience should Congress impose the proposed wine excise tax ($.87/gal.) as well as the non-deductibility provision (an additional $.73/gal.). Please keep in mind that the increased excise tax will be:

1. Absorbed by vintners; or
2. Passed back to winegrape growers in the form of reduced grape prices; or
3. Passed forward to consumers in the form of increased wine prices.

1. It is unlikely that it can or will be absorbed by vintners. The 1985 ITC study of wineries producing approximately 83 percent of American non-premium table wine, showed that in 1982, 70 percent of the wineries sustained operating losses. By 1984, 80 percent of the wineries were experiencing operating losses.
2. If the increase is passed back to winegrape growers in the form of reduced grape prices, it would amount to a reduction of $272.00/ton ($1.60/gal. x 170 gal./ton). That reduction is $111.00/ton more than the weighted average price paid for all California grapes crushed for wine in 1985 ($160.95/ton).
3. It has been estimated if the cost were passed forward to the consumer, wine sales will decrease by at least 10 percent or approximately 58 million gallons. Not only does that decrease mean reduced sales to vintners, but growers will lose a market for 350,000 tons of their grapes -- the production of about 50,000 acres.

The results -- in two out of three of the possible scenarios -- winegrape growers lose significantly! This is not the fault of the vintner, the wholesaler or retailer, it is simply the way our economy works.

In conclusion, the proposed wine excise tax increase would:

1. Have a disastrous effect on America's growing winegrape and wine industry consisting of about 7,000 winegrape growers and 1,200 vintners producing in 34 states (most are family enterprises).
2. Would probably result in all or a substantial portion of the increase being passed back to winegrape growers (1) because of the current tough marking situation forced by vintners; and (2) because of the economic losses experienced by vintners.

Unfortunately, it is a well documented economic fact of American agriculture that cost increases are passed back to the farmer, especially when supply exceeds demand, as is the current grape situation in California and when competition in the consumer market is intense as is the current situation in U.S. wine market.

I ask the Committee to consider the fallacy of increasing the burden through the application of a discriminatory excess tax on non-subsidized American farmers in order to generate funds to pay subsidies to other American farmers. It has been my understanding that Congress and Administration's policy is to encourage free market, non-subsidized American agriculture.

I ask that the Senate Finance Committee and the Department of Treasury reveal any economic evidence that all or a substantial portion of the proposed wine excise tax will not be passed back to winegrape growers in the form of reduced grape prices.

I ask whether it is sound policy to increase the U.S. excise tax on wine at the same time U.S. trade negotiators are carrying out the mandates of the Wine Equity Act designed to reduce tariffs and taxes and other restraints to free trade? It is inconsistent to expect other countries to reduce taxes on wine when the U.S. is substantially increasing its excise tax by 400 percent.

The proposal is not tax reform, it is taxation of small farmers, farm wineries, and the politically weak.

Those of us who labor in the vineyard suffer the risks, cycles and problems of farming. Those of us who make and sell wine experience the complexities of wine making and the realities of the market place. But we are all united in admiration of the most revered agricultural products in recorded history -- grapes and wine.

The Psalms tell us --

> "He causeth the grass to grow for the cattle, and the herb for the service of man; that he may bring forth food out of the earth; and wine that maketh glad the heart of man." (Psalm 104:14)

BEFORE THE SENATE FINANCE COMMITTEE

HEARINGS ON TAX PROPOSALS INCLUDING A PROPOSAL TO RAISE EXCISE TAXES ON WINE

TESTIMONY OF THE CALIFORNIA RAISIN BARGAINING ASSOCIATION

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May 2, 1986

BEFORE THE SENATE FINANCE COMMITTEE

HEARINGS ON TAX PROPOSALS INCLUDING A PROPOSAL TO RAISE EXCISE TAXES ON WINE

TESTIMONY OF THE CALIFORNIA RAISIN BARGAINING ASSOCIATION

The California Raisin Bargaining Association represents more than 2000 grape growers who produce raisins. These same growers often also market grapes to wineries for crushing. Because grapes like the Thompson variety that are produced by these growers are multipurpose and used in both raisin and wine production, a reduction in market demand for any single use will immediately and adversely affect the price received by growers from all markets.

The Association and it members, therefore, have a direct interest in the health of the U.S wine industry and in the recent proposals for an increase in the excise tax on wine. Factors that affect the well-being of U.S wine producers and the competitiveness of their products have an immediate impact both on the price that the Association's members receive for their grapes and raisins and on their ability to sell the fruit that they harvest.

If domestic wine shipments decline because of higher net prices to consumers, wineries produce less and reduce the level of their purchases from grape growers. Vineyard owners, who traditionally send a proportion of their harvest to wineries, are then forced to either leave the grapes on the vine to rot or to find another market. The only other significant outlet is the raisin market. The grape surplus that arises when grapes that are normally crushed are forced into raisin production creates a desperate price situation for our industry. This situation is evidenced by declines in sales revenues, increased inventories, losses in land values and a record number of farm foreclosures. Thus, raisin inventories more than tripled in the last four years as wine shipments contracted. Current inventories are more than twice the volume of total annual sales. Moreover, the value of vineyards in California alone declined by approximately one-third, or $3 billion, since 1981, reflecting the inability of many grape growers and raisin producers to recoup their production costs in a market in which prices have been suppressed.

An increase in the excise tax applicable to wine and an elimination of the business deduction for excise taxes on wine could not come at a worse time for the domestic wine industry, U.S. grape growers and raisin producers. Shipments of U.S. table wines already have declined significantly in the last three years. Domestic shipments of generic table wine in 1981 equaled 241 million gallons. By 1984, the level of shipments had declined to approximately 219 million gallons, or by more than 9%. Another significant decrease occurred during 1985. By all indications, this decline in shipment volume occurred despite generally constant, but in many instances lower, prices. Statistics available from the Department of Labor, for example, show that the Consumer Price Index for wine increased by only 1/10th of one percent in 1983 and actually declined by 1.3% in 1984. In comparison, the Consumer Price Index for all products increased by 3.2% and 4.3% in 1983 and 1984, respectively.

Reduced shipment levels have made it impossible for U.S. wineries to raise prices without risking further sales volume reductions. Yet, at present, many major U.S. wineries are shipping products at prices that do not cover their production costs. Low wine prices and a no-growth market for table wines translate into lower prices, and sometimes insolvency, for grape growers and raisin producers as well.

Some wineries, confronting increased production costs and a market that has made price increases impossible, have ceased or reduced their operations. One major California winery has placed four of its five facilities on the block for sale. Others have cut back their crushing to 20 percent of levels in earlier years. All have sought, and many have obtained, lower input costs by persuading or forcing suppliers, such as grape producers, to lower their prices to the wineries. These factors are reflected in the decline in the revenue per ton received by grape growers in the State of California, which produces almost 90% of U.S. table wine. Between 1979 and 1981, the revenue per ton received by growers ranged from $156 to $205. Since 1981, revenue per ton steadily has declined until it equalled $108 in 1985. For certain grape varieties used in both wine and raisin production, 1985 values fell to as little as $50 per ton. Cash costs of production, however, have increased to more than $140 per ton with total costs substantially higher.

Statewide revenues also reflect this downward price spiral. In 1981, total revenue from wine grape varieties was $327 million. In 1984, that sum was reduced to $189 million, or by 42%. The imposition of an increased excise tax will not only reduce this tax base but it will destroy it and create additional fiscal burdens for social programs at the local, state and national levels.

The current condition of the marketplace will make it impossible for wine shipment levels to remain constant, while the price per bottle of wine would be increased by no less than $.70 because of an increased excise tax. The $.70 price increase is equal to between 15 and 30% of the current retail price for a bottle of table wine. A price increase of that magnitude will accelerate an already sharp decline in shipment volume.

An elimination of the business deduction for excise taxes on wine will also detrimentally affect the volume of sales and prices received by U.S. wineries and growers. Wine wholesalers that operate on a volume basis and with small margins have been able to deduct the excise taxes they pay on wine. With an elimination of this deduction, these wholesalers have only two choices: to force lower contract prices on wineries and growers or raise the price to consumers, thereby reducing sales volume. Either alternative will negatively affect the U.S. wine industry and raisin producers.

The adverse effects of the excise tax proposals would have had serious consequences for the wine industry and grape growers even during the early 1970's, when the industry was enjoying rapid growth. Given the conditions of the industry today, it can only spell disaster. In the present financial circumstances, either an increase in the level of the excise tax or an elimination of the tax deduction for excise taxes would come at a time when the domestic industry is already reeling from growing penetration of its markets by imports and an overall decline in U.S. consumption of alcoholic beverages. Battered by consumption declines and wine imports that have suppressed price levels and already represent nearly 30% of U.S. consumption, the U.S. wine industry and grape growers cannot and should not be expected to bear a new and unnecessary burden--additional excise taxes. For these reasons, the Association strongly urges that this Committee recommend that both the proposal for an increase in the excise tax and an elimination of its deductibility under our tax laws be rejected.

CORRECTED

Before the Senate Finance Committee

STATEMENT OF
NORMAN F. SHARP, PRESIDENT
CIGAR ASSOCIATION OF AMERICA

(May 5, 1986)

The Cigar Association of America opposes proposals pending before the Committee (1) to deny income tax deductions for Federal excise taxes and tariffs, and (2) to index the Federal tobacco taxes. The Cigar Association, whose members account for 90% of the large (traditional) cigars*/ sold in the United States, believes these proposals are unwise in general and harmful to the U.S. cigar industry in particular.

The U.S. cigar industry is small. It is also a depressed industry. There are 112 cigar factories throughout the United States, employing some 4,500 Americans. Most production is concentrated in Pennsylvania, Florida, Alabama and Georgia. The value of industry shipments in 1985 was $327 million. U.S. large cigar consumption in 1984 was 3.4 billion cigars and retail consumer expenditures for such cigars totalled $701 million.

The U.S. cigar industry has been in decline since 1965 when sales peaked at 8.5 billion units. Sales in 1985 totalled only 3.1 billion units, the lowest level in more than 100 years. The industry decline has been steady, as indicated in the following table:

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*/ Large cigars are defined as those weighing more than three pounds per 1,000 cigars.

Year	Unit Sales (billions)
1965	8.5
1970	7.9
1975	5.7
1980	3.9
1985	3.1

It is important to understand that, unlike some other products that are subject to excise taxes, cigars are highly price-sensitive. That is, the price elasticity of demand for cigars is such that increases in price will affect demand in a negative way. This has made it very difficult for the cigar industry to pass on cost increases to the consumer without suffering reduced sales. Thus, the trend in cigar prices lags well behind general price trends reflected in the Consumer Price Index.

Denying cigar companies the income tax deduction for Federal excise taxes would effectively increase their excise tax burden by a substantial amount. Given the price sensitivity of cigars, any increase in the Federal excise tax would have an immediate adverse impact on the U.S. cigar industry, its investors, its workers and the communities in which they live and work. The Federal excise tax on cigars is already high: 8.5% ad valorem with a ceiling of $20 per 1,000 cigars. The effective tax rate is even higher because the tax base is not the manufacturer's actual sales price, but rather a theoretical price from wholesalers to retailers, generally found in the manufacturers' price lists from which they discount to arrive at their prices to wholesalers.

In addition, the revenue produced by an effective increase in the excise tax on large cigars would be small and short-lived because the cigar market would soon shrink drastically. The trend line in revenue collections from this source is already unfavorable, as shown below.

Year	Federal Excise Taxes (million)
1981	$ 39.7
1982	37.7
1983	36.9
1984	32.7
1985	29.1

Thus, the potential for additional revenues from cigar taxes is extremely limited. Ultimately, an increase in the cigar excise tax would be self-defeating for the simple reason that it would necessarily reduce the tax base. This is so whether a cigar tax increase is achieved by making it nondeductible for Federal income tax purposes or by raising the ceiling on the existing *ad valorem* cigar tax. The trade-off for such a small and temporary revenue gain would be a crippling blow to the hard-pressed American cigar industry - clearly, a bad bargain and unsound from a public policy point of view.

On April 22, 1986, the cigar industry requested the Office of United States Trade Representative (USTR) to seek a reduction in EC tariff and nontariff trade barriers to enable

U.S. cigar manufacturers to expand their exports to that major market. Surely, this is not the time for the United States to place additional burdens on a U.S. industry struggling to survive at home and struggling to overcome formidable restrictions on market access abroad.

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON FINANCE

Statement on Behalf of
COALITION AGAINST REGRESSIVE TAXATION

HEARING ON
EXCISE TAX AND TARIFF CHANGES
PROPOSED AS PART OF TAX REFORM

April 21, 1986

Thomas J. Donohue
President and Chief Executive Officer
American Trucking Associations

My name is Thomas J. Donohue; I am President and Chief Executive Officer of the American Trucking Associations (ATA). ATA is a national federation representing all types and sizes of for-hire and private motor carriers.

SUMMARY

This statement is presented on behalf of the Coalition Against Regressive Taxation (CART), a new umbrella group for organizations opposed to the excise tax and tariff changes included in the Finance Committee's markup document. CART does not have a formal membership, but a large number of organizations and companies, large and small, have been represented at the weekly meetings ATA has hosted. Many of them have reviewed and approved this statement.

Participants in CART are united by their opposition to the following proposals: (1) an end to deductibility for all excise taxes and tariffs, (2) indexing of fuel, tobacco, and alcohol taxes, and (3) a five- to six-fold increase in the wine tax, plus related technical changes in the collection of these levies.

Although these changes have been defended as the glue that holds tax reform together, in fact they are the antithesis of tax reform. They are regressive. They amount to denial of inescapable, legitimate business expenses that will result in sharp, selective tax increases on widely scattered taxpayers, many of whom already pay high effective tax rates. They are quite possibly both unconstitutional and a violation of U.S. obligations under the General Agreement on Tariffs and Trade. According to a recent poll, they are opposed by a majority of voters. In short, they have no place in tax overhaul legislation.

A REGRESSIVE AND UNFAIR BURDEN ON INDIVIDUALS

CART commissioned deSeve Economics Associates to examine the net impact on individual taxpayers of the proposed income, excise and tariff changes. deSeve is a highly respected economic consulting firm that produces revenue estimates and burden tables using the same methodology as the Joint Committee on Taxation and Treasury staffs. The full deSeve study is included as Attachment I to this testimony. A few points deserve to be highlighted.

The study shows that the lowest-income taxpayers pay a disproportionate share of excise taxes and tariffs. Specifically, the under-$10,000 income class, with 3% of income, pays 8.1% of excise taxes and tariffs. The $10-20,000 income group, with 9.1% of total income, pays 14.7% of federal excises and tariffs. In contrast, the $200,000-and-over income class has 5.9% of income but pays only 2% of these levies. (See Table 1, p. 5 of deSeve study.)

As a result, increasing excise taxes and tariffs across the board, which nondeductibility would do, inevitably burdens taxpayers at the low end of the income scale more than the wealthy. This is a defect that cannot be remedied; an expanded earned income credit can give relief to some of the poor, but not the unemployed, retired, or near-poor.

Indeed, the excise and tariff changes would take away more than 60% of the benefit of the proposed income tax reductions for the lowest income class, and 45% of the benefit for all classes, but only 6% of the benefit for the highest income class. (See Table 3, p. 9 of deSeve study.)

This leaves the under-$10,000 group with a dramatically reduced net tax cut of only 12.9%, rather than the 77.2% cut resulting from income tax changes alone. Including excise and tariff changes also undermines the progressivity of the tax cut: the over-$200,000 income class actually gets a larger cut than any group between $20,000 and $200,000. For all income groups, the net tax cut falls to 4.2% of total income, excise, and tariff liability instead of 8.4% of income tax liability alone as initially reported by the Finance Committee. (See Table 5, p. 12 of deSeve study.)

This 4.2% cut is roughly half of the 8.2% overall cut provided by the House bill and the 8.8% cut under the President's proposal, when both are restated to measure all individual changes as a percent of total income, excise, and tariff liability. (See lower half of Table 4, p. 10 of deSeve study.)

In short, the proposed changes would rob the lowest income taxpayers of most of the tax relief promised by this package. Moreover, the changes would greatly reduce the progressivity of the income tax cuts, and would cut relief for all individuals nearly in half. These results are illustrated in the three charts immediately following this statement.

AN ARBITRARY AND SELECTIVE TAX INCREASE

Ending deductibility would effectively raise taxes for businesses that now claim a deduction for excises or taxes. Such a denial of legitimate, unavoidable business expenses would be unprecedented and extremely arbitrary. It has no more justification than denying the costs of goods used in production, labor, or employer's Social Security and unemployment taxes.

The wine tax increase would be an even more explicit tax boost, and the indexing proposal could yield large tax increases for industries producing or using motor fuels, tobacco, and alcohol. None of these changes in excise taxes is appropriate for financing income tax overhaul.

These increases would be spread widely through the economy, because there is a multitude of goods and services subject to excise taxes and customs duties. The increases would also be very uneven, because companies losing a deduction differ greatly in their ability to pass forward the higher taxes. In the trucking industry, for instance, for-hire trucking companies, private carriers, and owner-operators indirectly or directly pay nearly $5 billion per year in excises on fuel, equipment, and highway use tax. Railroads pay no federal excise taxes. As a result, truck operators that compete with rail, as well as many others facing stiff competition within trucking, would have to bear the full tax increase without passing it on.

This particular example highlights how selective and unfair the excise and tariff increases are. Trucking already has one of the highest effective income tax rates and rail one of the lowest. A Joint Committee on Taxation staff study for 1980-83 showed their respective rates were 38.2% and 2.4%. Yet nondeductibility and indexing would make this gap worse. Many of the other industries involved in CART also have high income tax burdens as well as excise or tariff burdens, and would be similarly affected. This group of proposals is a highly discriminatory method of increasing taxes on a variety of products without regard for the purposes of the levies and their effect on industries and consumers.

The degree to which the increases would fall on individuals in their role as consumers or as workers and owners of businesses would vary with each product and industry. This varying incidence points up how arbitrary the proposals are, particularly since the variation arises in large part from the denial of unavoidable and legitimate business expenses.

CONSTITUTIONAL AND FOREIGN TRADE SHORTCOMINGS

Two documents prepared for CART by several eminent law firms raise serious questions about the constitutionality of denying deductibility for excise taxes or tariffs and whether such a proposal violates U.S. obligations under the General Agreement on Tariffs and Trade (GATT). These papers are included as Attachment II.

To summarize both papers briefly, excise taxes and tariffs are a capital cost of the goods on which they are paid that must be subtracted from gross receipts to compute gross income. There is a very significant risk that the failure to permit this adjustment to gross receipts would result in the imposition of an unapportioned direct tax on capital, which is not permitted under the Constitution.

Further, it is possible that the nondeductibility proposal could be challenged as an increase in tariffs above the GATT schedules, in violation of Article II of GATT. In addition, U.S. trading partners could take the position that this proposal is a measure to protect domestic production in violation of Article III. Finally, withdrawal of the tax deduction for tariffs could constitute actionable "nullification and impairment" under Article XXIII.

It would be extremely short-sighted, and disruptive of our tax and legal system generally, to enact a tax reform package whose centerpiece can be challenged on constitutional or international trade grounds.

AN UNPOPULAR IDEA WITH VOTERS

CART commissioned a public opinion poll on these proposals shortly after they were released. The poll, a telephone survey of 1018 voting-age Americans (18 and over), was conducted March 21-23 by R. H. Bruskin Associates, using standard scientific methods. The full report on the survey is included as Attachment III.

By a 44%-to-19% margin, respondents opposed a tax package that was described as including lower rates for individuals and corporations, paid for with an end to deductions for some state and local taxes and and higher federal excise taxes on some consumer products. (See Q.1, p. 6 of Attachment III.)

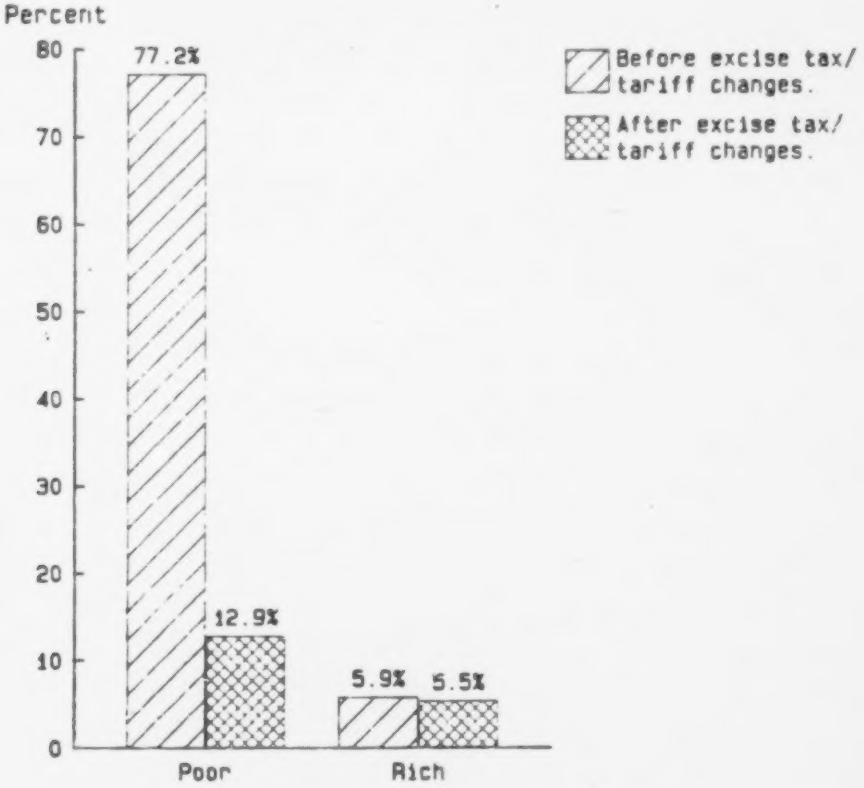
Response to a proposal to increase excise taxes automatically as product prices rise was even more negative, with 64% opposed and only 13% in support. (See Q.3, p. 10 of Attachment III.)

Clearly, voters do not believe these proposals belong in a tax reform package.

CONCLUSION

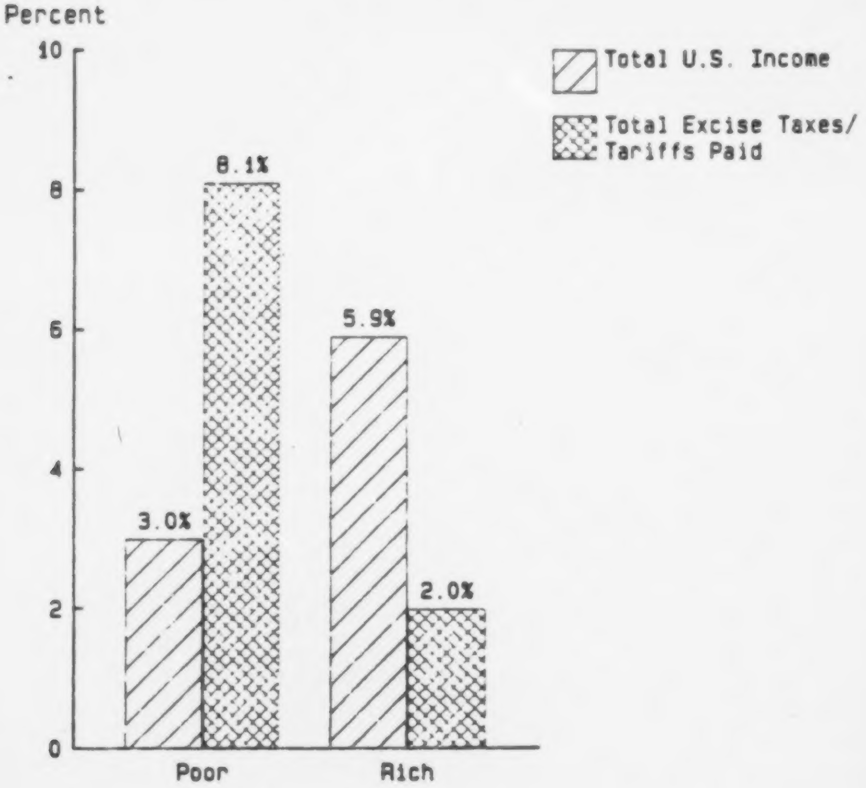
Tax reform is not worthy of the name if it is based on the nondeductibility of excises and tariffs and on sharp increases in selected excises. These proposals are regressive, inequitable, arbitrary, potentially disruptive, and unpopular. The Finance Committee should reject these ideas before proceeding further with its markup.

Senator Packwood's Package
Tax Cuts for the Poor and the Rich
(Incomes of $10,000 or less and over $200,000)

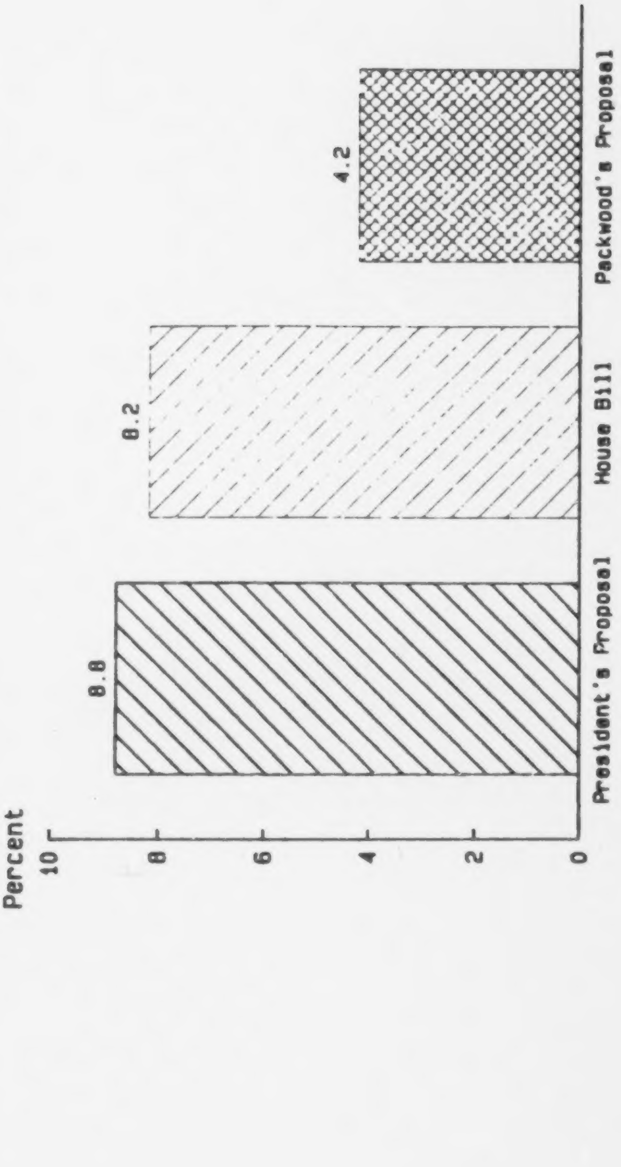


This chart compares tax cuts for the poor and rich before and after accouncing for the excise tax and tariff changes.

THE POOR PAY MOST
Impact of Excise Taxes and Tariffs
BEFORE Doubling Under Packwood's Proposal



Poor -- $0-$10,000/year
Rich -- Over $100,000/year



Comparison of Overall Tax Cuts
for all Income Classes
After Excise Tax and Tariff Changes

Coalition on Smoking OR Health
A PUBLIC POLICY PROJECT WITH THE
NATIONAL INTERAGENCY COUNCIL ON SMOKING AND HEALTH
1607 New Hampshire Avenue, N.W., Washington, D.C. 20009
(202) 234-9375

April 22, 1986

Betty Scott-Boom
Senate Finance Committee
SD219
U.S. Senate
Washington, D.C. 20510

Dear Betty:

Enclosed is a letter of endorsement for the excise tax provisions proposed by Senator Packwood as they apply to cigarette excise taxes.

The Coalition on Smoking OR Health would appreciate your including this letter in the record of yesterday's hearing, immediately following Matthew Myers' statement for the record.

Thank you for your assistance. Please let me know if there is any difficulty with fulfilling this request.

Sincerely,

Susan L. Arnold

Susan L. Arnold

Enc.
SLA/mad

CIGARETTE SMOKING IS THE SINGLE MOST PREVENTABLE CAUSE OF DEATH IN THE UNITED STATES

Coalition on Smoking OR Health
A PUBLIC POLICY PROJECT WITH THE
NATIONAL INTERAGENCY COUNCIL ON SMOKING AND HEALTH
1607 New Hampshire Avenue, N.W., Washington, D.C. 20009
(202) 234-9375

STEERING COMMITTEE
Alan C. Davis, Chairman
American Cancer Society
Robert G. Weymueller
American Lung Association
Scott D. Ballin
American Heart Association
STAFF DIRECTOR
Matthew L. Myers
Asbill, Junkin, Myers & Buffone
ASSOCIATE DIRECTOR
Susan L. Arnold
Asbill, Junkin, Myers & Buffone

April 21, 1986

The Honorable Bob Packwood
Chairman
Senate Committee on Finance
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is to advise you of our endorsement and support of the excise tax provisions included in your proposed tax package, as they apply to cigarette excise taxes.

Our reasons are simple. Eliminating the business tax deduction for cigarette excise tax payments and linking cigarette excise tax rates to consumer prices will result in higher cigarette prices. Higher cigarette prices lead to decreased cigarette consumption, especially among teenagers. This conclusion was reached by a Harvard University report published last year. As national public interest organizations concerned about our nation's health and our nation's youth, we support increasing the price of cigarettes because it will reduce the incidence of smoking in the next generation of potential smokers.

The human toll taken by smoking is appalling: more than 350,000 lost lives per year, or nearly 1000 deaths per day, are caused by smoking. In addition, cigarette smoking costs our economy $65 billion annually, according to the Office of Technology Assessment. Requiring the cigarette industry to pay the full costs of being in the business of selling death and addiction, and increasing cigarette excise taxes, are two ways for the Federal government to recoup a small portion of the cost burden imposed on our society by smoking.

We believe eliminating the business tax deduction for cigarette excise tax payments, and linking excise tax rates to consumer prices, stand on their own as excellent ways to increase Federal revenues and improve the public health. We urge the Committee to adopt these provisions as they apply to cigarette excise taxes whether or not you ultimately adopt a tax reform bill, and without regard to any other provisions in the tax reform bill now under consideration by the Committee.

Sincerely,

American Heart Association
American Lung Association
American Cancer Society
American Public Health Association
American Academy of Pediatrics
Association of State & Territorial Health Officials
American Nurses Association
American Society of Internal Medicine
National Association of Children's Hospitals and Related Institutions
American Licensed Practical Nurses Association
American Council on Science and Health
American Association of Preferred Provider Organizations
American College of Chest Physicians
Joint Council on Allergy and Immunology
American College of Osteopathic Pediatricians
Terri Gotthelf Lupus Research Institute
American Association of Medical Students
American Academy of Otolaryngology - Head & Neck Surgery, Inc.
American Diabetes Association
Asthma & Allergy Foundation
Adventist Health Network
Association of American Cancer Institutes
American Society of Clinical Oncology
American Association of Dental Schools
American College of Physicians
American College of Obstetricians & Gynecologists

THE
COST
COALITION

CONSUMERS OPPOSED TO SECRET TAXES

Co Chairs

Rev. Robert J. McEwen, S.J.
Professor of Economics, Boston College
Former President
Consumer Federation of America

Kathie Klass
Former Executive Officer
California Consumer Advisory Council

Steering Committee

James Deal, President
NE ARKANSAS Citizens Committee

Gordon Bivens, Professor
Department of Family Environment
IOWA State University

Clyde Chapman, Director
Consumer Affairs Association
Lawrence, KANSAS

Dennis Alonzo, President
LOUISIANA Consumers League

Toby Lapakko, Director
Consumer Affairs
MINNESOTA AFL-CIO

Edward J. Metzen, Chair
Department of Family Economics
and Management
University of MISSOURI-Columbia

Sol Harge, Executive Director
Consumer Protection Association
Cleveland, OHIO

William Johnston, Professor
Consumer Studies
Center for Consumer Services
OKLAHOMA State University

Ralph A. Smith
(Executive Secretary,
OREGON Consumers League)

Stewart M. Lee, Chairman
Department of Economics and
Business Administration
Geneva College, PENNSYLVANIA

Edwin P. Palumbo, Executive Director
RHODE ISLAND Consumer's Council

Brad Wiewel, President
TEXAS Consumer Association

Sam Simon, Former President
Telecommunications Research
and Action Center
WASHINGTON, DC

P.O. Box 93711
Milwaukee, WI 53203
(414) 271-1421

April 25, 1986

Dear Senator:

I was extremely disappointed to have been denied an opportunity to testify on behalf of this consumer coalition at the Senate Finance Committee hearing April 21 on the excise tax issue. The fact that it was National Consumers Week makes the denial all the more difficult to understand.

As Founding President of the Consumer Federation of America, I am acutely aware of the concerns of consumers throughout this country. One of the greatest of those concerns is the extent to which excise taxes affect low and middle income taxpayers. If those taxes are increased -- which economists agree will be the effective result of the proposal, still on the table at this writing, to make them nondeductible -- those citizens in the low and middle brackets will bear the brunt of the cost.

The excise tax, as you know, is a hidden tax. Therefore, by definition, when that tax is raised, very few people know it. They only see the cost of their phone calls, clothing, liquor and gasoline rise. Is this to be the legacy of tax reform -- $75 billion secretly raised on the backs of people least able to afford it?

The enclosed testimony, which I would have given before the Finance Committee, summarizes my views. I hope you'll give it careful attention.

Sincerely,

Robert J. McEwen

Rev. Robert J. McEwen, S.J.

TESTIMONY SUBMITTED TO THE SENATE FINANCE COMMITTEE

BY REV. ROBERT J. McEWEN, S.J.

COCHAIRMAN OF CONSUMERS OPPOSED TO SECRET TAXES (CO$T)

APRIL 21, 1986

I deeply regret that as a long-time consumer leader, I was not allowed to testify before your committee. It is especially puzzling to me why you would deny my group -- and all other consumer groups opposed to Sen. Packwood's excise tax proposals -- a hearing during National Consumers Week.

Following is the testimony I would have given to your committee:

My purpose in being here today is to express the strong opposition of millions of consumers to proposals to eliminate corporate deductibility of excise taxes and tariffs, and to increase and change the method of determining excise tax liability.

If this were indeed, as Sen. Packwood described it, a change in tax law that would merely increase federal income taxes paid by business, I would not be sitting here. I might even welcome it. But it is not a new and better way to make businesses pay their fair share of taxes. In reality, it is a hidden and very heavy tax increase on consumers.

In the name of so-called "tax reform," the American consumer is about to be clobbered in a way that is almost deceitful.

Let me explain why I and many other people in our consumer coalition are so disturbed by this proposal:

First and foremost, the cost of this proposed tax will fall most heavily on those least able to afford it -- the low and middle income citizens of our country.

Second, the hidden nature of excise taxes works against the goal of true tax reform -- openness, simplification and greater fairness.

Third, excise taxes were established mostly to raise money for specific and laudable purposes. This proposal would raise money for no purpose other than to preserve tax loopholes for certain favored industries.

And fourth, taxing excise taxes is a historic departure from tax policy. It's a tax on a tax, and it's also a patently unfair imposition of a new tax on selected goods and services.

Excise taxes, of course, are hidden in the cost of various goods and services and are paid into the Treasury by businesses which act as tax collectors for the federal government. Many consumer organizations long have been troubled by the regressive nature of federal excise taxes --- which hit low and middle income Americans the hardest. As Andrew Brimmer, former member of the Board of Governors of the Federal Reserve System, has noted, "Excise taxes are among the most regressive elements in the nation's tax system. They fall heavily on low and middle-income families and individuals, and they diminish overall economic welfare. Because of their inherently negative features, any changes that would broaden the scope of excise taxes or increase their rates would make an already bad situation even worse."

There is no question that low and middle-income families and individuals are hurt most by excise taxes. According to a study by deSeve Economics, today people earning below $10,000 a year pay almost three times their share of excise taxes. That is, they earn three percent of the income in this country but pay over eight percent of the excise taxes. In contrast, those earning over $100,000, or 7.7 percent of the income, pay less than four percent of the excise taxes.

Is that what we want? A $75 billion increase in these hidden excise taxes -- slipped into the tax reform package in a guise that was supposed to render it invisible to consumers? A secret tax increase used to finance the cherished tax breaks of certain industries, borne by those least able to afford it? I think not.

Of course, the effect of this new tax will be not only to raise prices for items like gasoline, liquor and clothing. It will also take the heart out of the tax reform promise of reduced taxes for the poor. If these proposals are enacted, the promised reduction of 77.2 percent in income taxes for those in the lowest bracket will disappear to virtually nothing -- dwindling to 12.9 percent. I do not believe that is really what the Senate wants to do. It is certainly not what most Americans would want. In a recent poll of voters by the Fingerhut Granados Opinion Research Company, while a majority agreed that tax reform should make everyone pay his or her fair share, 77 percent opposed raising federal excise taxes on airfares, beer and wine, and other consumer items.

And who would benefit from Sen. Packwood's proposals? For starters, the rich, who pay a disproportionately low share of excise taxes and tariffs. But most of all favored businesses -- such as oil, gas and timber companies -- who are able to keep tax breaks that in essence are paid for by these same consumers.

But it isn't only the unfair distribution of this tax that so disturbs me. It is also its hidden nature.

If any tax qualifies as a secret tax, this one does. If the price on a product is raised, who knows whether the increase came from a crop failure, a rise in energy prices, price gouging, or a thousand other business reasons? Who would guess, as would be the case with these proposals, that the price hike was due strictly to an increase in excise taxes?

It goes against the whole American system to perpetuate secret taxes. And yet this new tax not only perpetuates excise taxes; in imposing a secret tax increase on what already is a hidden tax, these proposals carry this deceit to its illogical extreme. It's clearly another effort to tax Americans without their knowing about it, and I object to it in the strongest terms I can.

An important motive behind the whole tax reform movement was to make the system more fair. And just as important, to make it appear more fair. People simply didn't understand the system. They were confused by the endless complexities and loopholes. They saw the system as essentially negotiable only by the rich businessman and his attorney. The little guy was getting a raw deal.

But I ask you -- how is this a change for the better? How does imposing a $75 billion increase in a hidden tax help people understand their tax system better, or have more faith in its fairness?

Along with this new secret tax goes another proposal, a companion in absurdity. It is to tie excise taxes and tariffs to inflation. Thus, in the future, these hidden taxes would be increased automatically, without notice -- something that would run exactly counter to the policy which Congress adopted in 1981 to prevent income tax bracket creep that otherwise would be produced by inflation. That policy requires individual income tax rates to be reduced each year by an amount equal to the percentage rise in the Consumer Price Index during the preceding year. So to index excise taxes to increases in the CPI would aggravate further the regressive nature of these taxes compared with the federal income tax.

The injustice of this proposal toward individuals is clear. There are powerful arguments about its injustice toward business, too.

o What will the increase in diesel fuel prices that will result from this new tax do to industries like trucking and the thousands of jobs currently located in small, independent trucking firms? What will it do to the thousands of mom-and-pop liquor stores in cities throughout the country who must raise the prices of their products?

- If excise taxes were no longer deductible by businesses, the results would be severely negative for many small companies that run close to breaking even. Even if a company had no profit at all, it would still have to pay tax on this tax -- on money it not only received no benefit from, but which actually cost it money, both to collect and in the amount of sales it lost because of the higher prices that had to be charged to cover the tax.

  Faced with such unwarranted tax increases, businesses undoubtedly would be forced to scale back their operations and lay off employees. These burdensome cutbacks would be particularly heavy for small firms and for workers with few skills who would find it hard to find alternative jobs.

- This tax is not, as some people say, a corporate income tax. Income is earned. This money is collected for the government. It is money that doesn't ever -- at any time -- belong to the company. It obviously should not be taxed. If it is, the company will then transfer that tax to consumers, a large portion of whom will be low and middle income American.

In reality, this tax is a back-door consumption tax. And if Congress intends to tax consumption, let's debate that on its own merits.

o Excise taxes were imposed for specific purposes. For example, the excise taxes on gasoline and other fuels, tires, heavy trucks and truck parts were intended as user taxes to finance the interstate highway system, related highway safety programs and, more recently, mass transit. None of the new revenue from denying the excise tax deduction, however, would promote those goals.

o Far from advancing the efficiency and equity of the tax system, the usual goal of tax reform, this proposal would contribute to the divergent tax treatment of various industries.

o Non deductibility raises serious Constitutional questions. The Sixteenth Amendment authorizes an income tax, not a gross receipts tax.

I could go on. But when all has been said about the inherent unfairness of this proposal to business, and the illogic of it in the face of United States tax history, I must say that what disturbs me most is the deceitful, hidden nature of this tax increase and the gross unfairness of this proposal to the average American. Those who are poorest will be hurt the most, and in many cases, will not even understand what has been done to them.

To be considering a proposal of this kind during National Consumers Week -- and denying consumers an opportunity to make their objections heard -- is enough to make this consumer more than a little mad.

EAGLE RIVER DISTRIBUTING II, INC.

April 21, 1986

The Honorable Bob Packwood
U.S. Senate Committee on Finance
Room SD 219, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

Regarding the public hearing April 21, 1986, we wish to go on record as protesting the non-deductibility of excise taxes. We also protest any increase in the federal excise tax.

Sincerely,

EAGLE RIVER DISTRIBUTING II INC.

Thomas A. Neddo

TAN/np

120 Railroad, P.O. Box 486, Eagle River, Wisconsin 54521 (715) 479-9060

Lite
Miller High Life
LOWENBRAU
Meister Bräu

FIELD DISTRIBUTING COMPANY, INC.

April 24, 1986

The Honorable Bob Packwood
United States Senate Committee on Finance
Room SD 219, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

I am writing to express my feelings about the proposal to do away with the deductibility of excise taxes.

In my view, this proposal is tantamount to a declaration of war on business by government and is one of the most outrageously anti-business proposals ever to emanate from Washington.

Firstly, to refer to this issue as a "deductible" issue is a smoke screen. This gives the impression that we are somehow getting an unearned deduction for something. On the contrary, we are acting as tax collectors for the government and then almost immediately we turn the taxes we collect over to that very same government. The excise taxes we collect are clearly not income; the money is not ours, we can't spend it and we don't even keep it. Our ability to deduct excise taxes simply means we don't have to declare these excise taxes as income which they clearly are not.

Frankly, it is incomprehensible to me that this issue is even being discussed.

P.O. Box 785, Wilson, NC 27895 (919) 291-2585

Although I regret that it is necessary, I feel compelled to remind my government that, "You can shear a sheep once a year, but you can't skin him but once".

Washington, you are going too far!

Beer is already taxed nearly three times more than virtually any other product. Please hold the line on any new taxes on beer.

Sincerely,

Hyatt Field

Hyatt Field
President

HF/ag

STATEMENT ON BEHALF OF FLUE-CURED TOBACCO COOPERATIVE STABILIZATION CORPORATION'S OPPOSITION TO THE EXCISE TAX PROPOSAL IN THE "SENATE FINANCE COMMITTEE STAFF OPTION FOR COMPREHENSIVE TAX REFORM"

BY: FRED G. BOND, GENERAL MANAGER

Mr. Chairman:

I am Fred G. Bond, General Manager of Flue-Cured Tobacco Cooperative Stabilization Corporation, a tobacco growers' cooperative. This Cooperative serves approximately 60,000 flue-cured tobacco growers in North Carolina, Virginia, South Carolina, Georgia and Florida.

The officers and directors of the Cooperative oppose eliminating federal excise taxes and tariffs as a deductible for business income tax purposes in the tax reform legislation proposed as the "Senate Finance Committee Staff Option for Comprehensive Tax Reform."

We believe the effects of this proposal would have a severe economic impact on tobacco growers and their communities and will ultimately be a tax burden rather than a tax relief. This proposal could also circumvent the changes the growers have made within the last year to improve their financial position.

Under the excise tax approach, taxation could raise the federal cigarette tax from 16-cents to 25-cents per pack. An increase of this magnitude would likely cause a decline of 4 percent to 5 percent in demands for sales of tobacco products.

Domestic cigarette manufacturers purchase approximately 45 percent to 50 percent of our growers' production each year. Further declines in consumption would have a devastating impact on the tobacco growers' income.

Annual tobacco income in North Carolina alone could fall $40 to $50 million.

This excludes other items affected by the proposal directly related to the cost of farmers such as motor fuel and certain farm items which would be subject to excise taxes. The ripple effects of the Packwood tax proposal could moderate the price relief farmers have seen recently in the cost of purchased items necessary for production.

This proposal comes at a critical time in the farming community throughout the United States and for tobacco growers in particular.

The tobacco growers have walked a financial tightrope over the past several years like most farmers. They have witnessed firsthand what an increase in taxes on cigarette products can do to their product due to the 8-cents federal tax since 1982 has weakened their market and reduced income.

Mr. Chairman, you have indicated that you would propose changes to benefit the working poor if the excise tax provisions are found to burden them.

We ask you and your committee to take a real look at the direct and ripple effects this excise tax provision would create and consider other alternatives for revenue. This provision would be very crippling to the agricultural community.

I thank you for having this hearing, and for the opportunity to present these facts and concerns to you.

Prepared April 17, 1986

FLUE-CURED TOBACCO DATA:

Effects To Growers Substantially Related To The 8-Cents
Increase In Federal Tax Applied To Cigarette Prodvcts January 1, 1983.

Year	Base Quota Changes (Mil. Lbs.)	Domestic Purchases (Mil. Lbs.)	% Domestic Total	Farm Income To Growers (Mil. Dollars)
1982	1,013.0	478.8	51.2%	1,761.9
1983	910.0	441.7	49.4%	1,448.7
1984	804.5	454.0	48.6%	1,531.1
1985	773.7	440.0	48.9%	1,343.9

U. S. CONSUMPTION FOR CIGARETTE PRODUCTS:

1982 - 634 Billion Pieces

1985 - 594 Billion Pieces

6.7% Reduction

GETTYSBURG

Gettysburg College
Gettysburg Pennsylvania 17325-1486
(717) 334-3131

Department of Economics

May 1, 1986

Ms. Betty Scott-Boom
Committee on Finance
SD - 219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Scott-Boom:

In accordance with the instructions dated April 14, 1986, which I received from Mr. Diefenderfer, I am enclosing a written statement for inclusion in the hearing record on the excise tax provisions of the Chairman's proposal on tax reform. I appreciate your attention to my statement.

Sincerely,

Ann Harper-Fender
Associate Professor

Recent testimony by Assistant Secretary of the Treasury Department J. Roger Mentz before the Senate Finance Committee concludes with a qualified approval for the tax bill before the Committee. However, Mr. Mentz's qualifications are significant and should not be dismissed lightly as they concern the economic efficiency justification for increased excise taxes on particular goods, virtually the only point he makes in favor of the tax bill other than that it will raise tax revenues.

A priori, Mentz's support of excise taxes on some, but not all, goods and services violates the principle of tax neutrality. Under that principle taxes designed to raise revenue should distort or influence decision-making minimally. That is, the tax structure should not alter relative prices. Mr. Mentz justifies discriminatory taxes economically by arguing that the consumption or production of some goods generates external diseconomies or spillover costs to persons not consuming these goods. These external costs are not taken into account by those deciding how much of the goods to produce and consume because the costs, by definition of being external, are borne by others. Because private producers and consumers thereby underestimate the total costs involved in the consumption of the external diseconomy generating good, these decision-makers overproduce or consume this good relative to the socially optimal quantity. Mints argues that by increasing price to consumers or reducing net return to producers taxes on these goods force these decision-makers to consider full social costs. In essence, taxes force internalization of externalities, leading to reduced production and consumption.

Mentz posits that gasoline, alcoholic bereraqes, and tobacco products generate external diseconomies and, hence, excise taxation is potentially efficient. Even if one accepts his position on the potential for external diseconomies, the proposed tax does not necessarily lead to efficient shifts in relative after tax prices. For example, the external diseconomies generated by using a gallon of gasoline at 4:00 am on Sunday in central Wyoming likely differ significantly from those inflicted by using that gallon at 5:00 pm on a windless Friday in Los Angeles. Yet both gallons would bear the same excise tax. The location and timing of alcohol consumption greatly affects the probability that the activity will generate external diseconomies, but excise taxes do not vary accordingly. Further, nowhere in the arguments for the proposed increases in excise taxes is there an effort to link quantitatively those increases to the value of the external diseconomies; serious argument that the proposed tax increases are designed to improve economic efficiency by correcting for market imperfections should show that the taxes effectively approximate the external costs. Mr. Mentz suggests that the demand for the taxed goods likely is inelastic so that the taxes will fall primarily on the consumers whose consumption of the goods will not decline much. Given that quantity consumed will not decline significantly, the proposed taxes seem almost punitively inflicted if their motivation is to offset externalities.

Similarly, Assistant Secretary Mentz proposes that if production or consumption of a good or service benefits from tax supported facilities, then excise taxes are appropriate on those goods or services to finance the facilities. Thus, excise taxes on airline tickets can be justified because airlines use tax supported public airports. Alternatively, firms using airports can be charged directly for usage of the public facility; such direct user fees seem more likely to lead to efficient decisions from both users and suppliers than indirect charges via excise taxation. Unless collection costs are dramatically higher with direct user fees than with excise taxes, the former seems preferable economically to the latter.

Although Mr. Mentz's remarks address primarily the appropriateness of using excise taxes to change the relative prices of certain goods, he also comments on the incidence of the proposed taxes. He notes appropriately that short run relationships between consumption and income can be deceiving and that one should beware of concluding that taxes on consumption are necessarily regressive from the short run studies. However, even if a tax on consumption in general were not regressive, taxes on particular consumer goods may well be regressive. A recent simulation study by the Citizens for Tax Justice reports that these excise tax proposals overall would tax a relatively higher percentage of low family incomes than they would of high incomes.

If it is difficult to ascertain the incidence of the proposed excise taxes, at least in the short run, it is virtually impossible to legislate in advance that incidence. The Treasury Department seems to note that difficulty in its representative's remarks on the non-avoidance provisions of the proposed bill. If resources are free to move from taxed to untaxed industries, consumers of the goods from the taxed industries must eventually pay those taxes. Mr. Mentz observes that the provision disallowing the deduction of excise taxes collected from taxable income likely would have the effect of an elevated excise tax. Such being the case, why not avoid the serpentine maneuvers and raise taxes directly? Much has been said recently about the desirability of tax simplification; this piecemeal approach to limiting deductions from corporate income for tax purposes is unlikely to lead to tax simplification.

Perusal of the tax package currently proposed by the Finance Committee yields little in its favor except its attempts, in babyrinthian fashion at times, to raise revenue. Certainly persons concerned with the future of the U.S. economy cannot fault efforts to reduce the federal government's deficit. Whether the current tax bill is a good way to do this is another issue. The bill provides preferential tax treatment to some industries and consumers and makes up for revenues lost therein by increasing a host of excise taxes and tariffs. Within this context, Mr. Mentz's arguments favoring some excise tax increases seem ex post justifications for discriminatory tax increases.

Ann Harper Fender
Associate Professor of Economics
Gettysburg College
Gettysburg
Pennsylvania 17325

Great Western Malting Co.
division of PENWEST, LTD.

POST OFFICE BOX 1529
VANCOUVER WASHINGTON 98668-1529
206-693-3661

April 21, 1986

Senate Finance Committee
c/o Betty Scott-Boom
Committee on Finance
Room SD-219, Dirksen Senate Office Bldg.
Washington, D.C. 20510

Gentlemen...

Our company is deeply concerned about the committee's proposal to change the manner in which the brewing industry will be assessed excise taxes in the future.

The proposed changes will unfairly burden the already heavily taxed brewing industry. Furthermore, the impact of these changes will, in reality be born by the consuming public. The burden, will fall heaviest on lower income people by virtue of the fact that the vast majority of the beer consuming public are lower income citizens.

It is unrealistic to suppose that industry will pay this tax since ultimately all costs of doing business are paid by the consumer. The proposal, therefore, would be regressive rather than the traditionally progressive nature of U.S. tax systems.

We further believe that the additional cost burden will negatively affect beer sales. For generations beer has been the beverage of preference. That is desirable socially because of its relatively low alcohol content and its established position as a beverage of moderation. (More recently, there have even been reports of health benefits when beer is consumed in moderation.)

The increased excise taxes on the brewing industry will also have a negative impact on industries other than the brewing industry. Of those support industries, the agricultural community will be the greatest effected. Except for water, agricultural products including malt, corn, rice, and hops, comprise nearly all the ingredients used to brew beer. These crops represent approximately 200,000,000 bushels of agricultural products with a value of $500,000,000. To the extent this increased tax load negatively impacts beer, we expect adverse effects to hit the malting and milling industry and flow directly down to the farm level. This industry is already suffering from ineffective trade policies and the tax changes contemplated may well be viewed as heartless.

Our company purchases malting barley in the states of North Dakota, Montana, Idaho, Oregon, Washington, and California -- other firms purchase in additional states. Farmers located in these states, along with our employees and those of the corn milling industry, the rice milling industry, and the brewing industry itself, plus other supporting industries, will directly feel the distressing weight of your proposals.

In light of those considerations and on behalf of the farm community and an estimated 80 million consumers of beer, we appeal to you to reconsider your proposals, or at the very least, exempt beer from the measure.

Thank you very much for your consideration.

Respectfully,

Ronald B Vogel

Ronald B. Vogel
Executive Vice President &
General Manager

slb

cc Beer Institute
U.S. Senators for Oregon, Washington,
California, Idaho, & North Dakota

Hudepohl Brewing Company
505 Gest Street Cincinnati, Ohio 45203-1792 513/721-7273

April 16, 1986

Betty Scott-Boom
Committee on Finance
Room SD-291
Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Ms. Scott-Boom:

I would like to comment on Senator Packwood's tax increase proposal. I do not like the idea that this tax increase is aimed at the American Beer Drinker. This consumer is our labor force. Beer drinkers are blue collar workers who are already heavily taxed as beer consumers.

The consumer will also suffer under this proposal because eliminating the excise tax deduction will result in price increases by brewers to wholesalers who will have to increase their markup just to continue to earn a fair profit Retailers will have to do the same. The final result would be that consumers would have to pay two to three times more for beer.

It seems to me that Senator Packwood's proposal penalizes the brewers who are tax collectors for excise taxes. Under this proposal brewers would be taxed on the tax dollars they collect. That makes no sense.

The overall result of this proposal could be the loss of thousands of jobs in the brewing industry and related and supplier industries. Lost jobs means lost revenue to the government.

As a small brewer, a proposal like this would probably put us out of business. We want our jobs.

We are opposed to Senator Packwood's proposal to repeal the corporate deduction for excise taxes.

Sincerely,
HUDEPOHL BREWING COMPANY

Robert L. Pohl
President and C.E.O.

RLP/dcb

The Pride of the Cincinnati Brewing Tradition

STATEMENT

of the

INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION

on

DEDUCTIBILITY OF EXCISE TAXES AND TARIFFS

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

WASHINGTON, D.C.
April 21, 1986

The Independent Fuel Terminal Operators Association ("IFTOA") submits this statement opposing Chairman Packwood's proposal to deny deductibility of excise taxes and import tariffs paid to the federal government. The details of the Chairman's proposal are ambiguous, but it is clear that the changes proposed would severely penalize independent marketers and consumers of motor fuels, and would have impacts on competition in the motor fuels distribution sector far worse than direct changes in the levels of gasoline and diesel fuel excise taxes. Accordingly, IFTOA urges the Finance Committee to reject the proposed changes entirely as an ineffective and inappropriate element of tax reform.

IFTOA is composed of 16 companies which operate 56 deepwater and 40 barge oil terminals along the East Coast from Maine to Florida.1/ None is affiliated with a major oil company. Members are primarily marketers of residual fuel oils (Nos. 4, 5 and 6 fuels) and home heating oil (No. 2 fuel); several companies also market significant volumes of gasoline and diesel fuel at wholesale and retail levels. Members handle nearly 50% of the non-utility residual fuel oil shipped to the East Coast, nearly 60% of the non-utility residual fuel oil shipped to New England, more than 50% of the No. 2 fuel oil consumed in New England and nearly 25% of the No. 2 heating oil consumed along the East Coast.

1/ A list of members and a description of the Association is attached. (Attachment A).

I. Chairman Packwood's Proposal Relating to Motor Fuels

Chairman Packwood has proposed several changes in the law affecting the motor fuels distribution industry. First, he would deny any deduction for these businesses which collect and remit the federal excise tax on gasoline and diesel fuel.2/ Currently, the gasoline excise tax is 9 cents per gallon; the diesel fuel tax is 15 cents per gallon. Second, he would deny any deduction for the tariff paid by an importer of any fuel, including gasoline, diesel fuel, home heating oil, or residual fuel oil. Third, he would shift the point of collection for gasoline excise taxes and possibly diesel fuel taxes "upstream" to the refiner or importer level. This change would force all independent marketers to purchase gasoline and diesel fuel taxpaid, thereby impairing their cash flow and restricting the ability of non-refiners to sell to tax-exempt users. Each of these elements of the proposal would severely disrupt the operations of many marketers and would impair competition in the motor fuels industry generally.

2/ The proposal would not only deny a deduction for these excise taxes collected, but would also require payment of income taxes on the amounts of gasoline and diesel fuel excise taxes collected, regardless of the profit or loss of the entity collecting these taxes. Thus, even if a marketer of gasoline or diesel fuel incurred a taxable loss for the year, it would nevertheless be liable for payment of taxes on the amount of motor fuel excise taxes if collected.

II. The Adverse Impact on Motor Fuels Distributors

A. Non-Deductibility of Excise Taxes

The denial of a deduction for excise taxes collected and remitted by a taxpayer is grossly unfair. It taxes an entity for a service it is required to provide for the federal government. It also imposes a tax on a tax, which is not income to the taxpayer by any normal definition. Gasoline and diesel fuel marketers would be forced to treat as taxable income those funds they merely collect and remit as taxes to the government. These firms should be compensated for this service, rather than forced to pay additional taxes. The inclusion in taxable income of excise taxes seriously distorts the basic principle of the income tax that imposes taxes on income rather than gross revenues.

In addition to this fundamental unfairness directed only at those industries that collect federal excise taxes, the proposal disguises an increase in excise taxes as an increase in corporate taxes. In fact, this change will increase taxes paid by consumers, not taxes paid by corporations. There can be no doubt that the increase in taxes incurred by motor fuel marketers will be passed through to consumers in the form of increased prices. In most competitive markets, the increases will be passed through fully, just as would a direct increase in the rate of tax; in "soft" markets, the increase may only be passed through in part, until the market permits a full pass through. But it is deceptive to portray this change in taxation as an increase in corporate taxes when the inevitable effect will be increased prices for the consumer goods upon which the excise taxes are imposed.

Because these taxes ultimately will be imposed on consumers of gasoline, diesel fuel and other products, the effect will be extremely regressive and uneven. Price increases on these products could more than offset the decrease in income taxes to lower income groups resulting from other aspects of tax reform. Accordingly, we urge that the distributional, sectional, and regional effects of the proposal be evaluated before excise taxes are increased directly or through this subterfuge.

B. Non-Deductibility of Tariffs

The overwhelming majority of petroleum products sold in the United States are made from domestically refined crude oil. Less than 12 percent of our products are imported.[3] However, the economic availability of these imports is critical to the pricing of all domestically refined products, because the imported barrel is the marginal supply. Denying a deduction for payment of import tariffs on petroleum products would

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3/ See U.S. Department of Energy, Energy Information Administration, Annual Energy Review (1985).

effectively raise the costs of the imported product by 54 percent of the tariff, thereby providing a competitive advantage, as well as a massive subsidy, to domestic refiners.

Current tariffs on major petroleum products are: crude oil - .25 cents per gallon; gasoline - 1.25 cents per gallon; heating oil - up to .25 cents per gallon; diesel fuel - 1.25 cents per gallon; residual fuel oil - up to .25 cents per gallon; gasoline blendstocks - from 1.25 to 15 cents per gallon. Denying a deduction for these tariffs paid would increase the effective rates of each of these duties by 54 percent. This increase would have two unintended impacts.

1. Anti-Competitive Effect

First, it would place independent importers and marketers of motor fuels at a severe disadvantage in their competition with refiners. The relative disadvantage of importing gasoline, diesel fuel, or gasoline blendstocks compared to importing crude oil would increase substantially. There is no basis for altering the competitive balance in this way.

2. Subsidy to Refiners

Second, the effective increase in the cost of these product imports would provide domestic refiners the opportunity to increase their margin between their cost of crude oil and the price of petroleum products. An increased margin of just one half of a cent per gallon provides the domestic refining industry with increased profits in excess of $1 billion per year. Increasing the effective tariff on gasoline and diesel fuel from 1.25 cents per gallon to 1.925 cents per gallon (1.25 x 1.54) would provide refiners with a pre-tax subsidy exceeding $1 billion per year.

For these reasons, the Committee should evaluate carefully the anti-competitive effects of denying a deduction for import tariffs on petroleum products before any action is taken. The Committee must understand that changes in the comparative tariffs for crude oil and petroleum products will seriously impair the ability of independent marketers and importers to compete.

C. Changes in the Collection Mechanism

Under current law, gasoline excise taxes are collected by "producers" of gasoline, which includes refiners and wholesale distributors.4/ Diesel fuel excise taxes are collected at the retail level or, for fleet users, at the consumer level.5/ These povisions enable independent marketers to purchase gasoline and diesel fuel tax free and remit the tax to the federal government only after it has been collected. In addition, the existing collection mechanism permits distributors to sell gasoline tax free to other wholseale distributors, and allows retailers to sell diesel fuel tax free to educational organizations, to farmers, or for off-road use. Such uses are exempt from the tax.

4/ Internal Revenue Code, Sec. 4082(a).

5/ Internal Revenue Code, Sec. 4041(a).

If this collection point for either of these taxes is moved "upstream" to the refining level, both distributors and exempt users will be severely injured. Marketers will be forced to purchase their fuels "tax paid." Thus, in addition to the cost of the fuel, they will have to pay the excise tax in advance of this sale. This will require financing of the excise tax from the date of purchase to the date of sale. Such financing is extremely costly, and unavailable to some marketers. Refiners may not have to incur this additional cost of financing on sales through their company owned outlets. Thus, refiners could be provided with a significant competitive advantage over independent marketers.

In addition, exempt users would be forced to purchase their fuels "tax paid" if they purchased from independent marketers, but would not have to do so if they purchased from a refiner directly. Presumably, an exempt user would have to file for and await a refund of the tax paid to a marketer for deisel fuel. As a result of this discrimination, farmers and other exempt users will virtually be forced to purchase diesel fuel directly from refiners. This would deprive the independent sector of a substantial portion of business, and severely limit competition for these sales.

* * *

For all these reasons, the Chairman's proposed to modify the treatment of federal motor fuel excise terms should be rejected. IFTOA appreciates the opportunity to comment on this proposal and requests that this statement be included in the record of the Committee.

ATTACHMENT A

MEMBERS

INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION

Astroline Corporation
Saugus, Massachusetts

Belcher Oil Company
Miami, Florida

Bray Terminals, Inc.
Albany, New York

Colonial Oil Industries, Inc.
Savannah, Georgia

Global Petroleum Corp.
Waltham, Massachusetts

Meenan Oil Co., Inc.
Syosset, New York

Northeast Petroleum Corp.
Chelsea, Massachusetts

Northville Industries Corp.
Melville, New York

Quinoil Industries, Inc.
Quincy, Massachusetts

C.H. Sprague & Son Company
Boston, Massachusetts

Steuart Petroleum Company
Piney Point, Maryland

Swann Oil, Inc.
Philadelhia, Pennsylvania

Ultramar Petroleum, Inc.
Montvale, New Jersey

Webber Tanks, Inc.
Bucksport, Maine

Whaleco
Brooklyn, New York

Wyatt, Inc.
New Haven, Connecticut

The 16 companies listed above own and control terminals capable of receiving ocean-going tankers. None is affiliated with a major integrated oil company. Members of the Association are independent marketers of No. 2 fuel oil, No. 6 fuel oil, gasoline and other petroleum products.

They distribute more than 50% of the No. 2 fuel oil consumed in New England and nearly 25% of the No. 2 fuel oil consumed along the East Coast. They distribute nearly 60% of the residual fuel oil burned by non-utility consumers in New England and nearly 50% on the East Coast.

The 16 companies own and control 57 deepwater terminals and 42 barge terminals, with a total storage capacity of over 58 million barrels. Of the total, about 26 million barrels are for No. 2 fuel oil, about 24 million barrels are for residual fuel oil, and about 7.4 million barrels are for gasoline and other products.

STATEMENT TO BE
SUBMITTED FOR THE RECORD

BEFORE THE COMMITTEE ON FINANCE
United States Senate

On behalf of

INDEPENDENT GASOLINE MARKETERS COUNCIL
1133 Fifteenth Street, N.W.
Washington, D.C. 20005

on

Deductibility of Exise Taxes

Submitted by:
Jack A. Blum
Blum, Nash & Railsback
1133 Fifteenth Street, NW
Washington, D.C. 20005

April 21, 1986

My name is Jack A. Blum. I am the General Counsel of the Independent Gasoline Marketers Council, a trade association of non-branded wholesalers and retailers of motor gasoline.

The Council is opposed to making excise taxes and tariffs non-deductible. Excise taxes and tariffs are a cost of doing business for commercial consumers and a direct tax on individual consumers. The retailers, wholesalers and manufacturers who collect excise taxes are performing a service for their government.

Historically, the purpose of excise taxes has been to lower consumer demand for scarce commodities and services in time of war or other national emergency, as a "sin" tax, and as user fees to provide the facilities needed by businesses and consumers. The most clear example of the user fee is the tax on motor fuels which is earmarked for the highway trust fund.

Tariffs have been imposed to protect domestic industry from foreign competition and to raise revenue, but tariff levels and tariff schedules have been carefully adjusted to reflect industry specific problems.

The present proposal is a radical departure from these concepts. As we see it, the present suggestion is a form of national sales tax disguised as a corporate tax increase. The attempt to hide the tax increase by imposing it through a redefinition of income is transparent to us, and, we can assure you, will be equally transparent to our customers and your constituents. The sole purpose of the change in excise tax from a "cost of doing business" to "income" is to permit the committee to produce a "tax reform" bill filled with additional tax breaks for favored industries while still giving the appearance of having produced a "revenue neutral", progressive tax measure.

It won't wash.

Moreover, because it tinkers with a complex system of taxation which was imposed for specific purposes and included specific exemptions, the concept will create an administrative nightmare for the tax collectors and the customs service. Later Congresses will spend substantial amounts of time correcting the problems this proposal creates.

For the marketing sector of the petroleum industry, the single most distressing aspect of the proposal is that it is being put on the table to pay for continuing the tax breaks for crude oil producers.

Crude oil producers have too many tax breaks today. Simple economic analysis should tell you that the favorable tax treatment of crude oil exploration and development is in part responsible for the excess capacity which is now the source of the producers' problems.

In 1979, when the price of crude oil soared, every doctor, dentist and lawyer in America bought a piece of a limited partnership drilling for oil and gas. The treasury paid for most of the purchases. The economics of the drilling activity was based on "no risk, can't lose" thinking. Today the market is teaching those investors a harsh lesson. And it appears from the action of the committee so far, Congressional response is to retain and indeed amplify the benefits.

We believe that Treasury's original tax proposal was on the mark. It proposed eliminating the windfall profits tax which can't be collected and has been played for competitive advantage, and eliminating all the other special oil and gas provisions. The first proposal would have given us a level playing field for the first time in years.

The Department of Energy's FRS analysis of major energy companies produces the best arguments for ending tax breaks for crude oil production. Over the years the production end of the business has been uniformly profitable. Although it accounts for a relatively small percentage of the total industry investment, it accounts for a disproportionately large share of the profits.

Companies have been willing to lose money on refining and marketing because of the tax breaks and the "upstream advantage" they have provided. The result has been an industry which hasn't really cared about the market forces that affect the rest of the economy. One major company regularly built gasoline stations without any serious analysis of return on investment. Another company did not question whether it was economic to develop a particular oil well until the price of oil crashed this past January.

There is no serious economic argument for sheltering producers from commercial reality. Nor is there an argument for subjecting the independent downstream sector to competition from companies which are partially government subsidized.

Raising revenue by changing the definition of a collected excise tax to "income" and moving the point of collection to the producer level will cause a series of problems for independent marketers. First, it will increase the amount of working capital they must retain in the business because the cost of the goods they purchase and the cost of the inventory they carry will increase. We assume that oil prices will rebound again. When they do, the tax will increase with the price rebound, making the working capital issue even more significant.

Second, many end users of gasoline and fuel oil are tax exempt. Farmers, state and local governments, and the military fall into exempt categories. These exempt entities are supplied, in large measure, by distributors who will have to purchase product on a tax paid basis if the proposed excise tax change becomes law. The committee will be faced with finding a way of rebating the exempt entities in a timely fashion.

Third, making the excise tax into taxable income will have the effect of raising the alcohol blending subsidy from six to nine cents a gallon. The original Treasury tax proposal suggested ending the subsidy altogether pointing out the absurdity of paying a subsidy from the federal treasury of $25.20 for a commodity which substitutes for oil selling at $26.00 a barrel. It is even more absurd to pay a subsidy of $37.80 a barrel for the same commodity as the price of crude falls to $12.00 a barrel.

Further, the subsidy has gone to the wholesaler/retailer who blended the alcohol. Under the proposal it would be limited to refiners who paid the tax.

Fourth, the nondeductibility of tariff increases the anomalies in the gasoline feedstock tariff area. Out of hand, it increases the value of the Generalized System of Preferences by more than 50% and increases the value of the Caribbean Basin Initiative. It increases the value of imported naptha blendstocks relative to imported gasoline and will open the door to imaginative manipulation of the tariff schedules.

Fifth, every large wholesaler and retailer is in the trucking business or at the very least is a large consumer of common carrier trucking services. The increase in excise taxes on the trucking industry hits us hard by increasing our operating costs. The members of this association would rather pay higher corporate income taxes out of profit when they have profits rather than have the cost of doing business pushed up steadily in an environment where the ability to pass the costs through is questionable.

It may be that as a matter of public policy Congress wants to encourage oil production and decrease consumption. If that is the objective, how can a proposal which raises the effective tax rate of the windfall tax to 105% be explained? It is especially difficult to explain imposing that increase to pay for continuation and liberalization of the depletion allowance. Similarly if Congress wished to discourage driving, why not tell the consuming public that its excise taxes have been raised and show the increase on the pump?

Finally, we are opposed to the change in status of gasoline excise taxes as a raid on the highway trust fund. The fund is already in serious trouble as the highway system has suffered from the problems of the federal budget. Under this proposal, the revenue increase that comes from taxing the tax will not go to the fund, nor will the additional amounts collected through indexation.

In sum, we strongly oppose the excise tax proposal as it applies to the oil industry as well as the tax breaks for the oil industry which the proposal seeks to finance. We believe that present law is far superior to the "reforms" being proposed. The country would be better off if you left the tax code where it is today.

PROPOSED REVISIONS OF FEDERAL EXCISE TAXES AND TARIFFS

Testimony Submitted for the Record

by

Norman B. Ture, President

Institute for Research on the Economics of Taxation
(IRET)

to

The Committee on Finance
U.S. Senate

April 21, 1986

PROPOSED REVISIONS OF FEDERAL EXCISE TAXES AND TARIFFS

SUMMARY

The Senate Finance Committee has under consideration a number of proposed excise tax and tariff changes that would intensify the seriously adverse economic effects of these taxes. These changes would impair productivity, cost jobs and income, and waste our economic resources.

Selective excises not only burden purchasers of the taxed products and services, even more seriously they distort the use of production resources, resulting in less productive use of labor and capital. Those supplying these production resources sustain losses in income and wind up in production activities in which they are less well rewarded in real terms. The entire economy suffers from the dislocations resulting from selective excises.

Under one of the proposed changes, alcohol, tobacco, and motor fuels would be taxed on the basis of their prices rather than, as at present, on the basis of physical quantities. This change, if implemented, would result in increases in these taxes as their prices rise. Under present law, the adverse effects of these taxes decline as the prices of the taxed items increase. The economic disadvantages of these selective taxes would be intensified as a result of the proposed change.

Another of the proposed changes would deny the deductibility of Federal excise taxes and customs duties by a business in computing its taxable income. This change would have the effect of increasing the true rate of these excise taxes and tariffs, thereby intensifying their adverse effects on the economy. At the same time, nondeductibility of these taxes would increase the income tax rate on the true net income of the affected businesses. Instead of contributing to attainment of a level playing field, ostensibly a major objective of the current tax reform effort, this change would riddle the playing field with tax differential potholes.

Under a companion provision, taxable income at least equal to their excise tax liabilities would be attributed to businesses even if they had no taxable income, indeed, even if they sustained substantial losses. Taxing phantom income would be the ultimate in an Orwellian 1984 tax policy.

The proposed excise and tariff changes would raise an estimated $75 billion in tax revenues over the first five years, offsetting a significant part of the revenue losses from tax rate reductions, increases in the personal exemptions, and other revenue-losing income tax changes. The preponderant part of this additional tax burden would be borne by employees of the companies immediately affected by the proposed excise and tariff

changes. These tax changes would be a major element in a tax redistribution program, with those supplying the labor and capital services used in producing excise-taxed items bearing additional taxes to provide lower taxes for others.

The proposed excise tax and tariff changes would be a large step backwards in tax policy. They should be deleted from the tax reform package.

Introduction

Included in the tax reform proposals presented by Chairman Robert Packwood to the Senate Finance Committee on March 13, 1986, are major and drastic changes in the present income tax treatment of excises and customs duties and in the method of computing three major excise taxes. One proposal was to disallow the deductibility of all excises and tariffs by business income taxpayers; another was to impose alcohol, tobacco, and motor fuels excise taxes on the value of these products, i.e., on an ad valorem basis, rather than, as at present, on the basis of some physical volume measure of them, i.e., on an ad rem basis; a third proposal was to raise the rate of the excise on wine to make it equivalent to that now imposed on beer.

These measures would increase the revenues from excise taxes and tariffs by an estimated $75 billion over the first five years in which these changes would be effective. Roughly $63 billion would come from repealing the deductibility of excise taxes and tariffs, $11 billion from adjusting alcohol, tobacco, and fuel excises for price increases, and $1.5 billion from hiking the excise on wine. These revenue additions would be among the largest of those proposed in the tax reform package. Because that package is to be revenue neutral over the five-year revenue projection period, these additional revenues presumably are to be used to help offset the revenue losses estimated to result from the proposed reductions in individual and corporate income tax rates, the increases in the personal exemptions and standard deductions for individual taxpayers, and from a number of other proposed income tax revisions. As a result, these additional excise tax and tariff revenues would be one of the major elements in effecting a substantial redistribution of tax liabilities throughout the U.S. economy.

Just as significant, this huge increase in excise and tariff revenues over the amounts that would be realized under present law during the revenue projection period would be a sharp reversal of the trend of recent years. For many years, Federal budget receipts from excise taxes and tariffs have accounted for a decreasing fraction of total Federal budget receipts. In fiscal year 1940, excise tax and tariff receipts were 32 percent of all Federal budget receipts. Excise tax revenues increased in absolute amount during World War II, both because many additional excise taxes were levied and because the aggregate volume of economic activity expanded rapidly under the wartime forced draft economic conditions. Excise taxes and tariffs contributed a sharply declining share of total Federal tax revenues, however, because the sharp increase in income tax liabilities very greatly exceeded the growth in excise tax revenues. In the post war years, this decline has continued as income and payroll taxes have expanded. Between fiscal years 1950 and 1985, Federal excise tax and tariff revenues have fallen from 19.4 percent of total Federal budget receipts to 6.6 percent. In the absence of the proposed changes, the relative contribution of these revenue services, it is estimated, would fall to 4.4 percent in fiscal 1990. The proposed excise tax and tariff changes would bring this wholesome trend to an abrupt halt; over the five-year projection period, these changes would boost the share of total tax revenues accounted for by excise taxes and tariffs from about 5.0 percent to about 6.6 percent.

Against all significant criteria of good tax policy, the proposed excise tax and tariff changes would be a major step backward. The excise taxes and tariffs in the Federal revenue system are selective taxes; they are imposed at differing rates on selected products and services, rather than being levied at the same rate on all of the products and services produced and sold in the economy. As selective taxes, they have seriously adverse effects on the economy. The proposed changes would intensify these adverse economic effects, impair the economy's growth, interfere further with the most productive use of our production capability, and result in less real wages and less of all other income throughout the economy, compared with the levels that would prevail if these excise tax changes were not enacted. The redistribution of tax burdens that would result from these tax changes would be substantial; there is no reason to believe that these shifts in tax burdens would conform with any acceptable standards of either economic efficiency or tax fairness. If the current tax reform effort is to extend its reach beyond the income tax, it should seek to reduce, if not completely eliminate, selective taxes, not to increase their weight in the Federal tax system.

The Basic Economics of Excise Taxation

Selective excise taxes are guilty of a number of serious fiscal and economic crimes. The outstanding attribute of a selective excise tax is that it raises the cost of the product, service, or activity on which it is levied relative to the costs of products, services, and activities not subject to such taxes. The consequence is that relative costs and prices differ from those that would be determined in the market place by the conditions of supply and demand. Selective excise taxes, in other words, distort the relationships among the market's valuations of goods and services.

These changes in relative market prices, in turn, lead to changes in the composition of output and of purchases. If one may appropriately assume that free markets provide price and cost information that leads to the most effective use of production capability and a composition of output that best and most economically satisfies our demands, then the price-and-cost-distorting effects of selective excises must result in a less effective use of our production capability and a less satisfying market basket of goods and services.

An excise tax imposed on a product or service raises the cost of producing and selling any given amount of it. If the producer tries to raise the price of the product or service to cover this additional cost, purchasers will buy less of it. With a smaller volume of sales, clearly, total production of the taxed product or service must sooner or later decline. A smaller volume of output, of course, means that less production inputs are used by producers of the taxed products or services. As a consequence, total payments for production inputs decrease. Ultimately, the selective excise shows up in the form of higher market prices for the taxed product or service, a smaller volume of purchases of these products or services, hence a smaller volume of their output, less production inputs dedicated to their output, and reduced incomes to those supplying these production inputs. The excise drives a wedge between the price paid for the taxed product or service and the payments for the production inputs used to produce it. Because that wedge isn't present for nontaxed products and services, the prices of the taxed outputs must rise relative to those of the untaxed products and services.

Because imposing an excise doesn't -- can't -- increase anyone's total income, it must be clear that purchasers can't pay more for the taxed items without having to cut back on their purchases of other goods and services. In general, the imposition of a selective excise leads buyers of the taxed product or service to cut their purchases of them, presumably allocating more of their incomes to the purchase of other products and services. It also leads producers of the taxed products to cut back on their output, hence on their purchases of the production inputs that go into producing them; total payments by the producers of these tax outputs for these production inputs are also reduced. To be sure, the price of the taxed items goes up by some fraction of the selective excise tax imposed on them, and buyers are induced thereby to shift to some other market basket of products and services than the one they found most satisfying before the excise tax was imposed. But the major initial burden of a selective excise tax clearly is borne by those supplying the production inputs to producers of the taxed outputs.

In fact, the story about the incidence of the selective excise doesn't end here. Many of the production inputs used in producing products and services subjected to selective excises will be more or less specialized to that production, at least for some period of time. To the extent that the amount of these production inputs used in producing the taxed items is reduced as a result of the levying of the excise tax, they are likely to remain idle until they can be adapted to other production uses. The employees who are let go when output is reduced in response to the imposition of a excise may be out of work for some time until they acquire new skills or locate other jobs in which they can use their existing skills, albeit less productively than in their prior use. In time, presumably, these production inputs will be used in other lines of production, but in some cases, this will occur only if the rates of payment for these inputs and for all of the inputs in these other production lines are less than they otherwise would be.

Customs duties create similar distortions. These taxes make imported raw materials, imported manufactured inputs, imported consumer goods, etc., appear artificially expensive. Assuming that foreign suppliers are unwilling to absorb all of the tax themselves, the tariffs handicap American buyers -- producers and consumers -- by arbitrarily raising the costs of imports, denying Americans some of the advantages of foreign trade. American consumers are hurt when they buy imported products bearing tariffs because the tariffs tend to increase the prices of those products. Consumers will also be hurt when they buy American products that contain some imported inputs because the tariffs raise production costs; some part of this cost increase ultimately shows up in product prices.

At issue in the proposed excise and tariff changes is not whether the additional excise and tariff burdens will be borne by consumers or businesses; both consumers and producers will bear the additional tax load. Consumers will do so principally by having to rearrange their consumption, winding up with a less satisfying market basket. Those supplying the labor and capital services for the production of the taxed items bear the burdens in the form of reduced income, at least for some time after the excise is imposed or raised. Because most of the products subject to federal excises are produced in labor-intensive operations, roughly 75 cents of every dollar of income loss attributable to these excises is borne by labor.

The distortions of output and of input uses and the losses in consumer satisfactions that are imposed by the imposition of selective excises are serious and substantial economic burdens. Because of the use of selective excises in the nation's tax system, the economy's production capability is less productively used than it otherwise would be. Selective excises, in other words, are fiscal engines of waste. Wasteful uses of production inputs reduce the capacity of the economy to grow over time. In terms of the economic efficiency and growth goals of tax policy, therefore, selective excises should not be included in the nation's tax system.

Selective excises taxes also rank very low in terms of the fiscal criteria of "good" taxes. For the most part, these levies escape the painful awareness by those who must ultimately bear their burden. But hidden taxes are, for the very fact of their obscurity, bad taxes. If taxes and tax burdens are to enter into democratically determined decisions about how much of the economy's production capability is to be made available to government, people must be aware of these taxes and painfully conscious of their burden.

Assessment of the Proposed Changes in Excise Taxes and Tariffs

The proposed revisions of excise taxes and tariffs should be evaluated in the light of the basic attributes of these levies and their assessment in terms of fundamental tax criteria. On these grounds, the proposals score very poorly, indeed.

Increasing Selective Excise Revenues Moves In Wrong Direction

Although little reliance need be or should be placed on the estimates of the revenue consequences of particular tax revisions, the magnitude of the estimated revenue gains from the proposed excise and tariff revisions are surely strongly indicative of their severity. Virtually on the grounds of these revenue estimates alone, one might well conclude that the proposed changes would significantly aggravate the economic disabilities of the present selective excise tax and tariff system. If the revenue gain of $75 billion over the five-year projection period is deemed to be a reasonable estimate, these proposed revisions would increase revenues from these sources by about 32 percent over the amounts projected for the period under present law. Increasing the average weight of these taxes by close to one-third is moving in the wrong direction in the light of any appropriate objective of tax reform.

Shifting To Ad Valorem Basis Would Result In Higher Tax Rates

Apart from this consideration, the particulars of the proposed revisions are themselves highly objectionable. Arguments may be advanced in the abstract for preferring either an ad valorem or ad rem assessment of selective excises. As a practical matter in today's fiscal and economic environment, the proposal to shift from an ad rem to an ad valorem basis for the excises imposed an alcoholic beverages, tobacco, and motor fuels should be seen as a means for obtaining higher tax yields from these products over time, insofar as their prices rise, without having to rely on explicit legislative enactment of higher tax rates.

When imposed on an ad rem basis, selective excises' effective rates decline, in real terms, as the market prices of the taxed products and services increase. This erosion of the real effective rates of selective excises serves to moderate their adverse economic consequences. By converting these taxes to ad valorem imposts, this reduction in their real effective tax rates is averted, and their adverse economic consequences are maintained. Considerations of tax requirements for economic growth and efficiency militate strongly against switching these taxes to an ad valorem basis.

Denying Income Tax Deductibility Would Distort Measurement Of Net Income

As objectionable, indeed if not much more so, is the proposed repeal of the deductibility of selective excises and tariffs from gross income in determining the taxable income of business income taxpayers. Denying deductibility of these levies would increase their weight and their adverse economic effects.

Excise taxes and tariffs, no less than wages, energy supply costs, capital costs, raw material costs, etc., must be taken into account as costs associated with the production and sale of the taxed products or services. No less than any other production and sales cost, excise taxes enter into a business' decisions about how much of what to produce and to sell at what prices.

The income tax imposed on business net income has always provided for the deduction of all costs incurred in the processes of production and sale, although, to be sure, the manner in which these deductions have been allowed has at times been changed and often has not accorded with the requirements of neutral tax treatment. But to deny the deductibility of excise taxes and tariffs would be to distort the measurement of the net income produced by a business just as much as would denying the deductibility of payrolls, raw materials, etc.

Present law quite correctly includes Federal employment taxes as part of employees' compensation and as payroll costs, fully deductible by the employer business in determining taxable income under the income tax. These employment taxes are, in economic terms, selective excises, virtually identical in their basic economic attributes to any other excise tax imposed by the Federal government. If there were any economic or fiscal justification for repealing the deductibility by a business of, say, the gasoline excise tax, there would be no less justification for repealing the deductibility by business of employment taxes. Repeal of employment tax deductibility would, obviously, have an enormously adverse effect on employment costs, on employment, and on labor income, as well as imposing wrenching distortions of the composition of economic activity. Repealing the deductibility of the Federal selective excise taxes would have very much the same sort of devastating economic effects, even if somewhat less severe in magnitude.

Denying Income Tax Deductibility Would Intensify Economic Distortions

Because the excise taxes in the Federal revenue system are not applied uniformly to all production and sales of all products and services, but are, on the contrary, highly selective, denying the deductibility of these taxes would result in grossly differing effects among businesses. Businesses involved heavily in producing and selling products and services subject to selective excises, obviously, would find the net-of-tax costs of their operations increased relative to those of other businesses. The prices of their outputs would have to go up and the volume of their output would have to contract relative to that of other businesses, as would their employment of labor and capital services and other production inputs. Repealing the deductibility of excise taxes and tariffs in measuring taxable income for income tax purposes would intensify the distorting effects of these levies.

Denying Deductibility Would Increase Tax Rates

Disallowing deductions for excise taxes and tariffs, moreover, would also increase the rate of income tax actually falling on business incomes correctly measured as net of all costs incurred in the production of that income. Equivalently, the repeal of excise tax deductibility would increase the effective rate of these excise taxes. These effects are highlighted in the hypothetical case summarized in the following table.

Nondeductibility of Excise Taxes: Effects on True Rates of Income Tax and Excise Taxes

	Present Law	Proposed Revisions	
		Income Tax Effect	Excise Tax Effect
Gross Receipts	$100	$100	$100
Less: Cost of goods sold	55	55	55
Gross profit	45	45	45
Less: Other expenses	30	30	30
Excise tax:			
Actual	5	5	5
Equivalent	5	5	7.69
Deductible	5	-	7.69
Taxable income	10	15	7.31
Income tax @ 35 percent	3.50	5.25	2.56
Total taxes, actual	8.50	10.25	10.25
Income tax as percent of actual net income of 10	35	52.5	25.6
Excise tax as percent of:			
gross receipts	5	5	7.69
actual net income	50	50	76.9

Repealing excise tax deductibility would raise the income tax liability in this case by 50 percent, from $3.50, under present law, to $5.25, or from 35 percent to 52.5 percent of the actual net income of $10. Total excise tax plus income tax liabilities would increase from $8.50 to $10.25. If deductibility of excise taxes were retained, the same increase in total tax liabilities would result if the excise tax were $7.69 instead of $5.00, or nearly 54 percent more.

The extent of these hidden income tax rate increases would depend, obviously, on the amount of Federal excise taxes and tariffs paid by a business in relation to its other costs of production and sales. In view of the very substantial differences in the extent to which differing businesses incur these imposts and in the weight of these taxes in their total costs, repeal of the deductibility of excises and tariffs would differentially increase from one business to another the actual income tax rates on correctly measured taxable income.

If the income tax is not to fall with differing weights on equally profitable business operations merely because of differences in the extent to which these businesses are exposed to selective excise taxes, taxable income must exclude these excise taxes (indeed, all taxes paid by businesses). Failure to exclude these selective excises from taxable income means that the income tax itself will intensify the distortions imposed by the selective excises.

The proposal to deny the income tax deductibility of excise taxes is confined to Federal excises. Excise taxes imposed by other governments in the United States presumably would continue to be deductible in computing business net income for Federal income tax purposes. Distinguishing between a selective excise imposed by a state government and an identical or similar excise imposed by the Federal government in terms of economic effects or the most rudimentary principles of tax fairness must boggle the mind. It is impossible to find any basis in reason for disallowing the deduction of excise taxes imposed by one level of government while continuing to allow the deduction of the same or similar taxes imposed by other governments. This is certainly not to suggest that the excise taxes imposed by other governments should be disallowed as well; even if reason, logic, and basic principles of taxation did not preclude this result, the new fiscal burdens that would be imposed on state and local governments by the current tax reform proposals should do so.

Denying Deductibility Would Be at Odds With "Level Playing Field" Objective

Much has been made during the current tax reform effort of the desirability of providing a level playing field in the tax treatment of businesses with differing kinds of operations, differing production inputs, differing time patterns in incurring costs and realizing incomes, etc. Many of the proposals that have been advanced with this purpose in mind would, to be sure, miss the mark; many, indeed, would tilt the playing field against saving and investment and riddle that playing field with the potholes of differing business tax burdens on the basis of the kinds of production facilities they use. But these misses, for the most part, are mischances, the results of failure to understand the effects of various tax provisions in present law and in the various reform proposals. The proposed disallowance of deductions for Federal excise taxes and tariffs can't be excused on these grounds.

By far the most radical, indeed, astonishing of the excise tax and tariff proposals is the one requiring businesses to pay income tax at the top corporate rate on taxable income deemed to be at least equal to their excise tax and tariff liabilities, irrespective of the actual amounts of their net incomes. This presumably means that, merely by virtue of the fact that it is liable for payment of excise taxes, a company with a net operating loss, even one many times larger than its excise tax liability, would have to pretend that it had positive taxable income at least equal to the excise taxes it must pay and to pay income tax on this phantom taxable income. This imputation of taxable income and assessment of income tax liability where no taxable income exists is the Orwellian 1984 of tax policy. It could well serve as a disastrous precedent for more generally assessing tax liabilities without any reference to economic realities.

It seems clear that these proposed excise tax and tariff changes were advanced not in the interests of improving these levies nor in the interests of true reform of the income tax. They appear to have been advanced merely as devices for raising some substantial part of the revenues needed to offset the very large revenue losses that other features of the tax reform program would entail.

Proposed Excise And Tariff Changes Would Be Unfair Ways To Finance Income Tax Reform Revenues Losses

These revenue raisers, moreover, are presumed to be relatively painless; because they would not fall directly on individual income taxpayers as such but on business income taxpayers, popular resistance to these tax increases is probably deemed to be slight. The notion appears to be that only directly affected businesses would be injured by denying deductibility of Federal excises for income tax purposes. Although this is clearly not the case, although the economy as a whole will sustain the losses imposed by aggravating the distortions imposed by selective excises, these losses are not readily apparent and measurable by the average individual. The fact that they escape our awareness in no way abates the harmful effects of the proposed excise tax and tariff revisions.

Some may attempt to justify raising the excise tax cost of the production and consumption of tobacco products and alcoholic beverages on sumptuary or health grounds. If a good case could be made for transferring responsibility from the individual to the government for determining how much of what kind, if any, of these products to consume, that fundamental decision surely should not be made in the shadow of income tax reform. If the Congress wants to raise the real rates of all of the present customs duties, it should face the issue of intensified protectionism openly and squarely, not slip it under the tax reform rug. If a case could be made for gearing motor fuels excise taxes to the market value of motor fuels, that decision deserves to be made on its own merits and in the open, not hidden from view by the overshadowing arguments concerning income tax reform and the most effective and desirable ways of financing the revenue losers in the income tax reform package.

In this connection, the issue surely should be forcefully addressed whether producers and users of the products and services now subject to Federal excise taxation and tariffs should bear so large and disproportionate a share of the burden for financing the rate reductions and other revenue losers in the income tax reform effort. Enhancing the real burden of selective excises and tariffs certainly cannot be justified on its own merits. Asking some part of the population to pick up the chips for others in order to provide tax reductions and to do so through the proposed excise and tariff tax changes amounts to a kind of haphazard redistributive tax policy. Why should people who work in truck manufacturing, telephone communications, airlines, tire manufacturing, tobacco, alcoholic beverage, and other excise-taxed industries pay for the tax reductions of those otherwise employed? If tax policy is to be applied to the questionable assignment of redistributing income and wealth among the population, at least it should be done with some clear notion of who are to be the income transferees and who are to be the transferors.

Proposed Excise Tax And Tariff Changes Are At Odds With Economic Policy Goals

Apart from these issues, the likely economic effects of the proposed excise tax and tariff changes should be given substantial weight in the evaluation of these proposals. As already urged, the proposed revisions, by increasing the true rates of the excise taxes and tariffs, and differentially increasing income tax rates, would significantly enhance excise tax distortions of relative prices and costs, of the allocation of production inputs among their alternative uses, and of the composition of total output and consumption. These distortions, although difficult to perceive, to identify, and to measure are nonetheless real; the higher the true rate of the excise taxes and tariffs, the more severe these distortions become.

For this reason, the proposed excise tax and tariff revisions would, if enacted, seriously impair the efficiency with which the economy would operate. Production activity would be less productively undertaken. The loss in productivity would show up not merely in displacement of employees from their more productive to less productive jobs, but in loss in employment, at least during the transition period, and loss in real wages. Because some of the selective excises rest on products and services used throughout the business sector, moreover, the increase in their true rates resulting from the proposed changes would tend to raise production costs very widely throughout the economy. The adverse effects of these increases in costs, though not readily apparent, would nevertheless be real and would be in the form of less output, employment, and real income than would prevail if these changes were not made.

Conclusions

However useful the purposes to which the additional revenues to be derived from these excise tax and tariff changes might be deemed to be, they surely should not be undertaken without a thorough assessment of the costs they would inevitably impose. These costs are not readily measured, but they would be incurred as a result of the enactment of the proposed changes. Against any relevant economic and fiscal criteria of tax policy, these costs are excessive. The proposed changes in excise taxes and in their income tax treatment should be rejected.

MR. ROBERT H. GLOVER
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MEMBERS OF THE COMMITTEE:

THE SENATE FINANCE COMMITTEE RECENTLY DISCUSSED A TAX OVERHAUL PROPOSAL THAT INCLUDED DISALLOWING THE DEDUCTION OF FEDERAL EXCISE TAX PAYMENT FROM CORPORATE INCOME TAXES.

THIS IS A BACKDOOR METHOD OF RAISING TAXES THAT WILL INCREASE OUR COST OF PRODUCT AND WILL RAISE THE COST OF BEER TO THE 80 MILLION CONSUMERS WHO ENJOY OUR PRODUCT.

WE OPPOSE ALL INCREASED TAXATION ON THE BREWING INDUSTRY. THIS INDUSTRY REPRESENTS 189,500 DIRECT JOBS AND BILLIONS OF DOLLARS OF FEDERAL AND STATE TAX REVENUE. OUR CONSUMERS NOW PAY MORE FOR THE TAX ON BEER THAN FOR THE INGREDIENTS AND LABOR COMBINED. BEER TAXES ARE ALREADY THREE TIMES HIGHER THAN MOST OTHER CONSUMER PRODUCTS.

AS YOU MAY KNOW OUR STATE AND LOCAL TAXES IN GEORGIA ARE NOW THE SECOND HIGHEST IN THE COUNTRY. WE DO NOT NEED ADDITIONAL TAXES ON BEER IN ANY FORM.

STATEMENT FOR SENATE FINANCE COMMITTEE ON SENATOR PACKWOOD'S FEDERAL EXCISE TAX AND TARIFF PROPOSALS

Statement of
Joseph M. Jadlow
Professor of Economics
College of Business Administration
Oklahoma State University
Stillwater, Oklahoma 74078

April 30, 1986

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present my views with regard to the proposals in Chairman Packwood's tax reform document concerning excise taxes and tariffs. The Packwood Plan would make Federal excise taxes and tariffs nondeductible for Federal income tax purposes, raise some excise taxes, and adjust the rates of Federal excise taxes on some products as prices in the future increase.

In his Statement before this Committee on April 21, 1986, Assistant Secretary of the Treasury J. Roger Mentz pointed out that the elimination of the deduction for Federal excise taxes would have the same economic effects as a direct increase in Federal excise taxes. I agree with this conclusion, and I agree that sellers of the taxed goods and services would attempt to pass the economic burden of the proposal on to purchasers~~, in th~~e form of higher prices. I disagree, however, with the justifications offered by Assistant Secretary Mentz for this increase in excise taxes. As I explain below, the effective increase in Federal excise taxes proposed in the Packwood Plan would be likely to reduce both economic efficiency and equity in the U.S. economy. Because of this, I oppose the Packwood Plan.

Economic Effects of an Increase in Federal Excise Taxes

As Assistant Secretary Mentz noted, the extent to which the burden of an increase in excise taxes is imposed on consumers rather than producers depends on the respective elasticities (i.e. responsiveness) of demand and supply for the taxed good or service. The less responsive that consumer purchases are to changes in price, the more the relative burden of an excise tax increase will be passed on to consumers in the form of higher prices; moreover, the more responsive (i.e. elastic) that the supply of a good is to changes in price, the more the burden of an excise tax increase will be passed on to consumers. In his Statement, Mentz pointed out that "the supply of most goods can be expected to be highly responsive to changes in price, since with sufficient time the quantity supplied of most goods can be increased (or decreased) at a relatively constant unit cost" [Highlights & Documents, Congressional News, April 22, 1986, p. L-100]. Thus, it is likely that most of the proposed increase in Federal excise taxes would be passed on to consumers in higher prices.

Optimal Tax Policy Considerations

Economists have generally opposed tax policies which involve the imposition of excise taxes on a few selected products because the taxes tend to distort the prices of the taxed products relative to other prices in the marketplace and, consequently, economic choices are distorted. The resulting efficiency distortions are reflected by the fact that some of the economy's scarce resources are discouraged from being used in their most valuable uses. This means that the use of excise taxes, and increases in them, tend to make consumers worse off by artificially raising some products' prices and by reducing the availability of these products.

To minimize such efficiency distortions, economic theory indicates that optimal tax policy considerations require that throughout the economy excise tax levels on different products would have to be determined in a very systematic way. One such approach would involve setting excise tax rates on goods in an inverse relationship to the price elasticities of demand for them. This would require higher tax rates on products for which consumers' purchases exhibit relatively low degrees of responsiveness to changes in price.

Assistant Secretary Mentz's Statement seems to imply that consumers have inelastic demands for some of the goods and services which currently are subject to Federal excise taxes and, therefore, an increase in these taxes would be consistent with optimal tax considerations [Ibid., p. L-101]. This is obviously not the case. Optimal tax considerations of this type would require much study of elasticity levels throughout the economy and then an across-the-board application of the inverse elasticity approach. Even then it is unlikely that adequate information would be obtainable for applying the approach correctly. Many goods for which there are relatively inelastic demands (e.g.s, prescription drugs, medical services, etc.) are not currently subject to Federal excise taxes and probably never will be. The imposition of excise taxes on a few selected goods and services, as is the case now, is a piecemeal approach which cannot be assumed to contribute to efficient resource allocation. An increase in the levels of existing excise taxes would make resource allocation even less efficient than it now is.

In his Statement, Assistant Secretary Mentz noted that one justification which is sometimes given for imposing an excise tax on a product is that the production or consumption of the product may cause spillover costs to other members of society. He cited alcohol as his principal example of a product which may generate some spillover costs to society; he also suggested that tobacco may impose spillover costs (although he does not indicate how this injury to innocent bystanders occurs) and gasoline (as well as other petroleum products) may cause spillover costs by generating air pollution and because reliance on foreign sources may reduce future economic growth. Mentz does not provide any information concerning empirical evidence on how large the spillover costs are from these products or whether there might be other products in the economy which generate spillover effects.

The implication of Mentz's comments is that existing Federal excise taxes are justified because there may be some spillover costs associated with some of the products on which they are imposed and, following the same reasoning, any increases in these taxes are also justified. The fallacy of this line of reasoning is that almost all goods and services produced in the economy generate some external costs and benefits. In order to determine optimal tax policies so as to insure that prices reflect all economic costs associated with each product at the margin, it would be necessary to know the exact sizes of any spillover costs generated by each product before deciding on the optimal excise tax for each product. This type of information is very difficult to collect. Mentz provides no such information in his Statement. His arbitrary selection of a small number of products as likely generators of external costs and his contention that it is therefore acceptable to impose increased Federal excise taxes on them is not consistent with optimal tax considerations. This unsystematic and piecemeal approach for imposing and increasing Federal excise taxes would almost surely make resource allocation in the economy much worse than it already is. Moreover, the arbitrariness of his approach is clearly discriminatory to both consumers and producers of the products which have excise taxes imposed on them.

In addition to the shortcomings in Assistant Secretary Mentz's Statement which have already been mentioned, there are analytical contradictions in his arguments. He claimed, for example, that petroleum products are underpriced in the market and do not reflect the spillover cost of reliance on uncertain supplies of foreign oil. It is not clear, however, why his recommended increase in Federal excise taxes on producers of domestic gasoline (and other petroleum products) would help reduce our reliance on foreign oil. While it might result in some conservation of petroleum products, it would also reduce the incentives that U.S. producers have to find new oil reserves.

Another major contradiction exists in the Statement by Mentz. As already pointed out, he argued that we should use excise taxes to promote reduced production and consumption of several products because they may generate external social costs. He then reversed himself by implying that the demands for the goods being taxed are unresponsive (i.e. inelastic) to changes in price, and therefore excise taxes on each of these ". . .would cause very little change in the amount of the good consumers would purchase" [Ibid., p. L-101]. He cannot have it both ways.

Distributional Impact

It is a basic principle of economic theory that excise taxes are regressive in their impact. In other words, they tend to take a larger proportion of the income of poor and middle income families than they do of high income people. This is because low income families tend to have to spend a larger proportion of their incomes on consumption than do high income families who can save and invest much of their income.

An increase in Federal excise taxes is likely to harm horizontal equity. In other words, the burden of the increased taxes may have a quite different impact on different people who have the same current income levels because the level and mix of consumption expenditures varies greatly among people. This is especially true for the elderly who typically spend large amounts from their savings on consumption that would be subject to excise taxes, even though they previously paid taxes on their income as they accumulated their savings. Furthermore, an increase in Federal excise taxes would also be likely to harm vertical equity because the level of consumption expenditures in a given time period does not always reflect the ability to pay (i.e. income) in an accurate way.

A recent study by the Citizens for Tax Justice found that ". . . families with the least ability to pay--especially young families and elderly households--were shown to bear the brunt of proposed increases in taxes on gasoline, beer and wine, tobacco, appliances, airline tickets, telephone calls and other consumer purchases" under the

Packwood Plan [News Release, April 21, 1986, p. 1]. This study also concluded that the plan would eliminate 79 percent of the tax relief which families earning less than $11,000 a year would receive from the House tax reform bill while median-income families would lose about 49 percent of their tax cut; families with income above $84,000 per year would be able to keep about 50 percent of their tax reductions [Ibid., p. 2]. In addition, the study found that the Packwood Plan would result in a net loss of 11,640 jobs in 32 states.

Conclusion

I am opposed to the Packwood Plan's proposal to make Federal excise taxes and tariffs nondeductible for Federal income tax purposes. For the reasons provided above, I am also opposed to any proposals (such as the one implicit in the Statement of Assistant Secretary of the Treasury Mentz) which would result in increases in selective Federal excise taxes. Such increases would distort economic choices and cause resources not to go to their most efficient uses. They would also have harmful effects on economic equity because of their regressiveness.

STATEMENT OF WILLIAM CARR
PRESIDENT, MINING DIVISION OF JIM WALTER RESOURCES, INC.
BEFORE THE
SENATE COMMITTEE ON FINANCE
HEARING ON DEDUCTIBILITY OF EXCISE TAXES
April 21, 1986

Mr. Chairman, I am William Carr, President of the Mining Division of Jim Walter Resources, Inc., located in Brookwood, Alabama, a wholly-owned subsidiary of the Tampa-based Jim Walter Corporation, which operates five (5) large underground mines in Tuscaloosa and Jefferson Counties, Alabama. These mines vary in depth from 1300 to 2300 feet in the Alabama coal-rich Warrior Basin. This mining complex employs more than 3700 people and will produce approximately eight (8) to ten (10) million tons of premium quality, low sulfur Blue Creek coal for customers abroad and in the United States. Jim Walter Resources leads the Coal Industry in new innovative ways of mining, including the development of the first modern longwall mining operation in the Southeast and a pace-setting coal degasification project which extracts more than fifteen (15) million cubic feet of methane gas per day from the coal seams prior to mining, providing both a cost-efficient energy source, and most importantly, adding to the safety of miners working underground.

It is our understanding that the Finance Committee proposes to eliminate the deductibility for income tax purposes of all federal excise taxes.

In general, all excise taxes are a direct cost of doing business and, as such, their deduction for federal income tax purposes is not a loophole as some have attempted to describe it. These taxes are just as much a direct cost of doing business, as are labor, labor-related taxes and materials used in manufacturing, mining and other businesses, and, therefore, the deductibility should not be eliminated.

Should their deductibility be eliminated, the selling price of the final product must be increased if the same profit margin is to be maintained. The increased cost must be passed on to the customer, and since it would affect all United States producers, the market probably will permit it. Thus, the final consumer will pay increased costs and inflation will gradually increase. It is, in fact, a regressive tax which will be paid by the consumer, many of whom are not in a position to pay increased costs for products and services.

Speaking specifically of the coal industry, the black lung tax that now is $1.10 per ton of coal mined underground is not really an excise tax, but a social tax enacted to fund disability for coal miners due to black lung diseases and, as such, is a normal cost of doing business. If the deductibility is removed, the cost of coal must be increased to maintain the same degree of profitability.

However, in this heavily depressed industry, there are very few, if any, mining companies that can normally raise their selling prices.

It is clearly apparent that a provision removing the deductibility of these taxes would have a major economic impact on the entire coal industry. The Price Waterhouse study shows the net after-tax effect of this proposal to be a 54-percent net increase. Looking at this in terms of the actual before-tax impact, the $1.10-per-ton black lung tax, effective April 1, 1986, when not deductible as a cost of doing business, is equivalent to a $2.04-per-ton black lung tax, thus having the same effect as an 85-percent increase in the income tax rate for this item, assuming that the same degree of profitability is maintained.

Speaking directly for our corporation, which depends on marketing a quality coal for export, we are now in a position of trying to compete with South Africa, Poland, Australia and others, who, in one form or another, control the selling price of their coal so that they may take a major share of world markets. We produce a high grade coal with the use of the best available technology, with more safety requirements than required by law, and with a very high degree of productivity, that is tons per man produced. Despite our high degree of productivity and our efficiency, looking at our operations alone, producing a quality coal at the least cost, the removal of the deductibility of this tax alone last year would have reduced our profitability last year to practically zero. Now, our world markets are shrinking, and the market price is so close to the cost of producing, that this additional tax on coal -- and this is just what the removal of deductibility amounts to -- will continue to shrink our markets.

As our market shrinks, so do our sales and, in turn, our production levels, and, finally, the number of jobs that we are able to provide. The loss of jobs will have a "rippling" effect on other jobs and the net effect is further loss of tax basis and could easily result in less, rather than more, taxable income at both the federal and state levels. In addition, it hurts this nation's balance of payments since most of our coal is sold overseas.

If the deductibility is removed, you are just adding an additional burden to the coal industry which, in the long run, will decrease the mining of coal, the one major natural resource that we have in this country, and the one energy material that our manufacturing industries and consumers may depend on in the years to come to provide a source of energy required to maintain our world position.

STATEMENT BY KENNETH A. KUMM, CHAIRMAN OF THE JOINT INDUSTRY GROUP IN OPPOSITION TO THE REPEAL OF THE DEDUCTIBILITY OF TARIFFS FOR DETERMINING TAXABLE BUSINESS INCOME

(Before the Senate Committee on Finance, April 21, 1986)

The Joint Industry Group would like to register its firm opposition to the tax reform proposal eliminating the deductibility of tariffs and excise taxes. Most of our members are opposed to this new departure in treatment of the long-recognized business expense aspect of excise taxes and tariffs. However, other business organizations are addresssing the great disadvantages of this proposed shift in tax policy respecting excise taxes, designed to gain tax revenue required by reform measures proposed for other tax areas, including, it is recognized, those to maintain or enhance U.S. industry's competitiveness in world markets.

The Joint Industry Group, a business coalition, (a description of activities and membership is attached), has customs matters as its primary interest. The Group is convinced that a change in the tax law repealing the deductibility of tariffs will produce revenue that is insignificant compared to the increased fiscal barriers to U.S. exports which are likely to be imposed by other countries.

The Joint Industry Group would like to note that the proposal for eliminating the deductibility of tariff duties was not considered in the exhaustive study conducted by the Department of the Treasury in developing the Administration's tax reform proposals.

Whether or not the import restraining effects of the measure played a part in developing the proposal, the Joint Industry Group feels it is a grave error to concentrate on the purely domestic impact of the proposal. To do so ignores the almost certain reactions by our trading partners, reactions adverse to U.S. export interest. Thus, the Joint Industry Group is as much concerned with the impact of the repeal of deductibility of tariffs on treatment of U.S. exports as it is with the unfortunate increase in the incidence of tariffs on U.S. imports.

As the Committee on Finance is aware, U.S. tariff concessions agreed to over the years in bilateral and multilateral trade agreeements and now covering almost all U.S. imports are commitments to maintain at, or reduce rates of duty on imports to, certain levels. The agreements further provide that no action should be taken to nullify or impair the value of such tariff concessions which are granted in exchange for similar reductions or bindings by our trading partners. Over the years changes in the method or basis of customs valuation, changes in product classifications and other measures which effect changes in the incidence of the rates of duty have been subject to challenge and negotiation of compensation in efforts to restore the balance of concessions between countries. The negotiations related to the adoption of the Customs Valuation Code in the Tokyo Round is a case in point.

Specifically, when the United States eliminated American Selling Price valuation as a result of the adoption of the new Customs Valuation Code, the rates of duty on imports covered by American Selling Price were renegotiated to reflect the equivalence of the rates of duty based on the new customs valuation base. Any change which reflects a higher cost of rates of duty subject to trade agreement commitments would be subject to challenge under the provisions of the General Agreement on Tariff and Trade.

It has not been possible in the time available to conduct a study of whether changes in the deductibility of tariffs in computing taxable business income has ever been reviewed as an impairment of tariff concessions in the General Agreement on Tariffs and Trade (GATT). However, almost no one would disagree with the conclusion that a shift from deductibility to nondeductibility of tariffs for tax purposes certainly does increase the cost of tariffs on imports. Inasmuch as such a change was not contemplated in the exchange of tariff concessions, this particular change in tax policy is likely to be considered by foreign exporters to the United States as an impairment or nullification of tariff concessions previously granted by the United States.

For this reason, the Joint Industry Group believes that this proposed change in the corporate tax system would violate U.S. commitments under the General Agreement on Tariffs and Trade (GATT). Further, the Joint Industry Group believes and expects that the United States would be subject, at the very least, to claims for compensation, very large claims; and at the most the United States could be subject to retaliation, possibly quite serious retaliation. In any event the response by our trading partners to this change in tax policy will be an increase in barriers to U.S. exports disproportionate to the effects of the tax change on the incidence of tariffs on U.S.imports.

Consider the fact that most other countries, except Japan, have higher rates of duty than does the United States, on the average. The United States average ad valorem equivalent is about 4 percent; in Europe the rate of duty is about 8 percent, Japan, 2-3 percent, and Canada, 8 percent. Add the factor that most other countries impose their tariffs on a c.i.f. basis (which includes the cost of freight and insurance), while the United States and a few other countries impose duties on a f.o.b. basis (free on board the port of export). Thus, if other countries chose to take action on deductibility of tariffs similar to that proposed in the United States, the increased cost of the tariffs would be far greater in almost all countries because the average rate of duty is higher abroad than in the United States and because the cost of freight and insurance would be included in the customs valuation base used in most other countries, but not by the United States.

In addition to higher rates of duty and a higher valuation base for assessing duties, most other countries have higher corporate tax rates. Thus, the proposed U.S. corporate tax rate of 35 or 38 percent (presently 46 percent) will be applied to the newly taxable income income of the average 4 percent tariff. This represents a potential increased tariff incidence in the United States of 35 percent, on average.

In West Germany, the corporate tax rate is 62 percent*, applied to the newly taxable revenue of 8.4 percent average tariff, including the additional factor reflecting the cost of freight and insurance of 4.6 percent, represents a potential increased tariff cost of 5.2 percentage points ad valorem. This is a 2.7 fold higher increased cost of tariffs on imports into West Germany than into the United States as a result of such a tax change.

In the context of today's atmosphere of questionable trade cooperation and lagging dispute settlement efforts, it is highly unlikely that our trading partners will avoid the opportunity to adopt the U.S. tax approach.

This is particularly true since the effects of emulating U.S. tax policy will be to penalize imports by raising prices to individual and to business consumers, raise revenue and engender much high tariff incidences for U.S. exports than would be the case for U.S. imports.

Another possibility is that other countries might choose to eliminate tariff deductibility on imports from just those countries which choose to eliminate deductibility of tariffs for corporate tax purposes.

The Joint Industry Group strongly request that the Committee members consider:

1) The wisdom of eliminating tariff deductibility for the purpose of determining taxable business income considering its unstudied and undocumented effects on individuals and businesses, and since we also believe the adverse impact on U. S. competitivness with direct imports also could be significant;

2) the likelihood that U.S. trading partners will be placed in a strong position to request compensation or to retaliate if the U.S. increases the incidence of GATT-bound rates of duty by repealing the deductibility of tariffs;

3) The proportionately much high market access burden that U.S. exports will face if the governments of other countries decide to emulate the United States and also eliminate deductibility of tariffs. Higher average rates of duty, a higher c.i.f. valuation base, and generally much higher corporate tax rates would raise the incidence of nondeductible tariffs on U.S. exports far in excess of similar action in the United States;

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*The average statutory tax rate in Europe is an estimated 50 percent, and in Japan is 58 percent.

4) This tax proposal and other measures which have been and are being considered by the Committeee on Finance, including the customs user fees on passengers and vessels and those proposed on customs clearance of commercial goods, plus fees to support port maintenance and improvement and special fees for adjustment assistance simply must be considered in the context of what other countries will choose to do in response.

The United States is struggling to achieve a more realistic value for the dollar and become more competitive in order to bring under control the current trade deficit. If the United States is to continue on a piecemeal basis to enact new fiscal impediments to imports, measures that can and will be easily replicated and imposed on U.S. exports by our trading partners, then the trade advantage of a newly aligned dollar will be seriously undermined. Further, these actions which are neither significant nor efficient revenue raising measures will harm the opportunities for future efforts at the cooperative lowering of world trade barriers.

There are legitimate concerns with the degree of market reciprocity for the United States in the context of existing international trading rules and practices. Such concerns are addressed in the trade proposals pending in the Congress. To enact a tax measure which impacts the cost of tariffs on U.S. consumers is highly questionable tax policy in the short run. To the extent that the measure negates United States trade agreeement obligations and also makes it highly likely that U.S. exports will experience similar and proportionately much high increases in the incidence of tariffs abroad is unwise tax policy and disastrous trade policy in the long run.

We urge the Committee to reject the proposal on nondeductibility of tariffs and excises as well.

(A list of the membership of the Joint Industry Group subscribing to this statement is attached to the description of activities and membership.)

PARTICIPANTS IN THE JOINT INDUSTRY GROUP SUPPORTING THE STATEMENT IN OPPOSITION TO THE NONDEDUCTIBILITY OF TARIFFS SUBMITTED TO THE HEARING OF THE SENATE FINANCE COMMITTEE, APRIL 21, 1986

Business Firms

American President Lines, Ltd.
Brunswick Corporation
Burroughs Corporation
Catepillar Industries
Control Data Corporation
Data General Corporation
Decision Data Computer Corporation
Dow International
Fujitsu America, Inc.
General Electric Co.
ITT, Cannon Division
International Business Machines Corporation
International Telephone and Telegraph Corporation
JVC Company of America
K Mart Corporation
Matsushita Electric Corporation of America
Mattel, Inc.
North American Philips Corporation
Northern Telecom
J.C. Penny Co., Inc.
Pioneer Video, Inc.
Polysar, Inc.
Procter & Gamble
RCA
Samsonite Corporation
Sprague Electric
The 3M Company

Trade Associations

Air Transport Association of America
American Association of Exporters and Importers
American Paper Institute
American Retail Federation
Council of American-Flag Ship Operators
Foreign Trade Association of Southern California
International Footwear Association
International Hardwood Products Association
Minnesota World Trade Association
Motor Vehicle Manufacturers Association
National Association of Photographic Manufacturers
National Bonded Warehouse Association
National Council on International Trade Documentation
National Customs Brokers and Forwarders Association, Inc.

Joint Industry Group listing, cont. -2-

National Association of Foreign Trade Zones
National Industrial Transportation League

Professional Firms

Anderson Hibey Nauheim & Blair
Arthur Anderson & Company
Baker & McKenzie
Barnes Richardson & Colburn
Wolf D. Barth Co., Inc.
Busby Rehm & Leonard
The Clawson Copmpany
Graham & James
Joseph & Schiller
Kadison Pfaelzer Woodard Quinnn & Rossi
Mudge Rose Guthrie Alexander & Ferdon
O'Connor & Hannan
Patton Boggs & Blow
Powell Goldstein Frazer & Murphy
Reynolds Allen & Cook
Rode & Qualey
Ross & Hardies
Sandler & Travis
Serko Simon & Abbey
Schnader Harrison Segal & Lewis
Sharretts Paley Carter & Blauvelt
Siegel Mandell & Davidson
Stein Shostak Shostak and O'Hara
Wilmer Cutler & Pickering
Windel Marx Davies & Ives
Washington, International Insurance Company

JOINT INDUSTRY GROUP

The Joint Industry Group is a coalition of manufacturing firms, trade associations, attorneys and other professionals actively involved in international trade. The Group examines the concerns of the busness community relative to current and proposed customs-related policies, actions, legislation and regulation and undertakes to improve them through dialogue, i.e. with the U.S. Customs Service, other Government agencies and the Congress.

Membership in the Group is open to all firms, associations and individuals having an interest in customs matters who are concerned with the stated purposes of the Group. The current membership of the Group exceeds 65 in number; its public positions are usually taken in the name of the Group and its trade association members, who include the:

Aerospace Industries Association
Air Transport Association
American Association of Exporters and Importers
American Electronics Association
American Paper Institute
American Retail Federation
Cigar Association of America
Computer and Business Equipment Manufacturers Assoc.
Electronic Industries Association
Foreign Trade Assocation of Southern California
International Footware Association
International Hardwood Products Association
Minnesota World Trade Association
Motor Vehicle Manufacturers Association
National Association of Foreign Trade Zones
National Association of Manufacturers
National Association of Photographic Manufacturers
National Industrial Transportation League
National Council on International Trade Documentation
National Customs Brokers & Forwarders Association of America

The Chairman of the Group is its Chief Executive Officer, who serves for a two-year term, with the possibility of an additional two consecutive terms. The current Chairman is:

Mr. Kenneth A. Kumm
(Manager, Customs & Trade Affairs, 3M Company, St. Paul, Minnesota)

Previous Chairmen have been:
1976 - Mr. William D. Eberle
(then President, Motor Vehicle Manufacturers Association, Washington, DC; Previously the President's Special Trade Representative)

1977-80, 1981-83 - Mr. David J. Elliott
(Manager, Customs Administration, Procter & Gamble Company; previously Deputy Assistant Secretary for Congressional Affairs, Department of Commerce)

1980-81 - Mr. Joseph A. DeRose
(then Director of Customs, IBM Corporation, Armonk, NY)

1984 - Mr. David R. Macdonald Esq.
(Partner, Baker & McKenzie Washington, DC; previously Assistant Secretary of the Treasury, Undersecretary of the Navy and Deputy U. S. Trade Representative).

The Secretariat of the Group is provided by Mr. Harry Lamar (previously Staff Director, House Ways and Means Subcommittee on Trade).

The Group has no dues per se, but its operating expenses are reimbursed by its members, budgeted at an estimated $250 per member per calendar year. The expenses are for the part-time services of the Secretariat plus mailing and related costs.

The Group's major accomplishments include:

1. Customs Procedural Reform and Simplification Act of 1978.
   This law modernized Customs' civil penalty statute by providing due process, judicial review and gradation of penalties based upon culpability and amount of violation. This replaced automatic forfeiture of the value of the goods regardless of whether deliberate fraud or technical error is involved. It also requires that importing companies keep records and provide Customs with reasonable access to them.

2. GATT Valuation Agreement
   This Agreement provided the major trading countries with a common standard for determining Customs' values. It is based on the concept that the price paid by a willing buyer to a willing seller is the best measure of value at a given time and place. This Agreement replaced diverse national laws that were often arbitrary, resulted in excessive values in commercial terms and could frequently create serious compliance problems.

3. Expedited Duty Collection
   The Group successfully convinced Treasury that efforts to accelerate duty collection from the present ten working day period following the import of goods was counter-productive in terms of net Federal revenue, Customs operations and the flow of commerce.

The Group has also proposed to Customs a procedure for modernizing its paper work processing, as is successfully being done in other countries, including England and Germany. A work program to install such a system is being examined by a Group Task Force in cooperation with the U.S. Customs Service.

Other issues that the Group is currently considering include inter alia:

1. Customs' tendency to emphasize enforcement activities at the expense of trade facilitation, equitable administration of the law and the needs of the U.S. economy.

2. Customs' proposal to collect "user's fees" for each customs entry, arriving passenger, etc.

3. The basis on which U.S. and foreign governments determine the country of origin of goods for Customs-related purposes.

4. An amendment to the current Customs Authorization Bill that would effectively eliminate the statute of limitations in Customs' penalty cases.

STATEMENT OF

KAISER COAL CORPORATION

BY CHARLES C. MCNEIL
PRESIDENT

TO THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON THE

DEDUCTIBILITY OF FEDERAL EXCISE TAXES AND TARIFFS

May 5, 1986

On behalf of Kaiser Coal Corporation, I appreciate the opportunity to present my views on the tax reform proposal being considered by the Finance Committee. Specifically, I want to address my comments to the proposal to eliminate deductibility for federal excise taxes paid.

Kaiser Coal Corporation, headquartered in Colorado Springs, has active mines and coal reserves in Colorado, New Mexico and Utah. Kaiser is a member of both the Mining and Reclamation Council of America and the National Coal Association, and we endorse the comments made to this committee by Mr. Daniel Scherder of Peabody Coal Company in their behalf. We mine both underground and surface coal, and pay significant amounts of excise taxes under a variety of federal requirements. Proposals which seek to deny companies the ability to deduct these substantial taxes from their taxable bases has the effect of creating "phantom income" where none in fact exists. Let me use one significant example, the federal black lung tax, to illustrate.

The black lung tax is not even a true excise tax, but instead is used to finance an employee relief program much like social security, federal workman's compensation and other similar programs. The entire coal industry will pay about $600 million in black lung taxes this year, partly due to a 10% increase just passed by Congress and effective April 1. At a time when energy rates are declining and competition among fuels is intense, coal prices often can't be raised to offset these increases. The black lung taxes, even when they can be added to the cost of coal, flow directly through the coal company and to the federal government. Yet under this proposal, they would be included in the taxable base of the company income, which will effectively increase the black lung tax by 54%.

That is not only bad tax policy, it is bad energy policy. By compounding tax increases such as we've experienced this year in the area of black lung taxes alone, and at a time of intense competition among energy sources, the Congress would shift demand away from domestic coal and toward fuels such as oil, which is much more import-dependent. This policy simply does not appear to be rational from the position of those of us who are trying to supply the country with its most abundant and useful fuel at the lowest possible price to the consumer.

Thank you for this opportunity to present my views.

Written Statement of Ernest E. Sears, Jr.,
Executive Director of the Kentucky Tobacco
and Candy Association
to the U. S. Senate Committee on Finance
on Excise Tax Proposals of the Excise Tax
Provisions of the Proposed Tax Reform Bill

The Kentucky Tobacco and Candy Association is an organization of wholesalers dealing in tobacco and candy products among hundreds, even thousands of other products. However, in all cases Tobacco Products and Candy Products are among the most important items on which the members of this non-profit association have built their businesses through the years.

In the State of Kentucky, the fortunes or the misfortunes of the tobacco wholesaler hinge directly upon the results of the tobacco market totally, including the grower, the warehouses, the processors, the manufacturers, the retailers and the many industries prospering from the production of the various segments of the total industry, and its employees.

There is no doubt in the minds of most all people in this industry that taxes improperly and unjustly levied can destroy every segment. Higher excise taxes on cigarettes, by whatever method, whether by not allowing deductibility or direct, is certain to reduce the market substantially in relationship to the amount imposed.

When any segment of the tobacco industry is abused or set upon with higher taxes or organized attempts that permanently injure the market, then the wholesaler in Kentucky will suffer, too. When taxes go up, the market is reduced in the amount of cigarettes bought by the consumer. There really is little room to even argue this point--if there is less money to buy, or if there is a higher price to pay, whether from higher taxation or for whatever reason--there must consequently be lower purchases from a limited number of dollars.

If purchases are lower, or less, then profits are less. If profits are less, then fewer people will work for the companies involved.

When few profits are made by wholesalers and manufacturers, the farmers lot has been made substantially worse. When the farmer makes less money, then the retailer sells less and the wholesaler sells less to the retailer, especially in a state like Kentucky, where a majority of the taxpaying public depend to some extent upon the prosperity or lack of prosperity of the tobacco industry.

There is no way to separate the economy of Kentucky and the financial situation of Kentuckians from the tobacco industry.

With the consumer in general paying nearing 50 per cent of the retail price of cigarettes in taxes in some form to a tax-levying level of government, it is time for all Americans to seriously take a look at the tax situation.

It is hope that Congress will be concerned about placing more taxes on industries already over-burdened with taxation,and consequently will not levy more excise tax burdens on the cigarette made from tobacco and other tobacco products.

Taxes hinged percentage-wise to the price of tobacco and candy products in particular would be offensive to future prosperity of the wholesaler. The impact of future price increases of product and services would be compounded in a detrimental way to the entire industry and consequently to the total economy of our area.

Major products handled by the members of the Kentucky Tobacco and Candy Association have for many years been undergoing a substantial amount of abuse from anti-crusaders on a rampage for one reason or another--sometimes against tobacco products, somestimes against candy products--and often against anything lawfully enjoyable or profitable toward the earning of a patriotic American's livelihood.

Without profit by private business, the free competitive enterprise system of the United States of America will be steadily sucked away into a vacuum created by excessive taxation restriction upon specific industry products.

I ask that the Senate Finance Committee reject any proposals relating to further excessive taxation or loss of deductibility of these products, especially tobacco and candy products.We are watching the number of farms and farmers dwindle away slowly as the pressures from a changing economy make it impossible for them to survive. As we watch the farms in Kentucky diminish in number, we must watch the number of farm-related and manufacturing-related jobs go down in larger and larger numbers, with consequently less payroll money in the state.

While this is going on, we must face the reality that within a few years, in Kentucky only a few businesses will be left that are tobacco and candy wholesalers as we know them today.

If Kentucky wholesalers make increasing amounts of profit, they will pay more taxes to the Federal government. If they make less profit, they will pay less taxes into the Federal treasury, and also provide fewer payroll dollars.

I feel the currently proposed non-deductible provisions and the proposals to place taxes upon taxes are impediments to continued success of this industry.

Respectfully,

Ernest E. Sears, Jr.

KEM DISTRIBUTING COMPANY, INC.

2604 CAUSTON BLUFF ROAD - SAVANNAH, GEORGIA 31404-1497 - TELEPHONE 912 233-1176

April 22, 1986

The Honorable Bob Packwood
United States Senate Committee on Finance
Room 5D 219, Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Packwood:

I have received information that claims your tax proposal will give working men and women a tax break. It seems to me that nothing is further from the truth. In fact, your proposal is a hidden tax, because companies---including Miller Brewing Co., Coors Brewing Co., and Stroh's Brewing Co.---of which I sell their products, will have to raise prices in order to continue to make a profit and survive. This price increase would directly effect beer consumers, mostly blue-collar working men and women. We all know that increased prices can lead to decreased sales, which would also have a drastic effect on state and local taxes that derive from the sale of beer.

My message is simple:
I oppose all taxation that have back door methods that masquerade as "Tax Fairness" or "Tax Breaks".

The U.S. brewing industry means approximately 189,000 direct jobs and billions of dollars already paid in federal and state taxes. American consumers now pay more for the tax on beer than for the ingredients and labor combined. America's 80 million beer drinkers already pay beer taxes that are three times higher than most other consumer products. It is indeed a cruel hoax to play on American consumers by offering them a tax break with one hand, then raise the prices of many consumer goods through a back door taxation method with the other hand.

C. Teel

Charles Teel
Cheif Executive Officer
Kem Distributing Company, Inc.

Miller Brewing Company . . Van Munching & Company . Stroh Brewery Company
Adolph Coors Company . . Royal Crown Cola Company

Kurth
MALTING CORPORATION

To: Betty Scott-Boom
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, DC 20510

From: John E. Busby, President
Kurth Malting Corporation

Re: Senator Bob Packwood's Proposal on Beer Excise Taxes
Date: May 2, 1986

I am opposed to Senator Packwood's proposals to eliminate excise tax deductions for beer, increase excise taxes on beer and indexing beer excise taxes for the following reasons:

1. Both in terms of its effect on consumers and of its impact on the brewing industry, the Packwood plan would exact a cost far in excess of any benefit derived by the Federal Government.
2. It does not close a corporate loophole...it raises taxes on 80 million American beer drinkers.
3. Consumers will pay more than $2 for every $1 the government realizes.
4. Beer drinkers already are heavily taxed.
5. This proposal falls unfairly on America's working men and women.
6. Eliminating this tax deduction penalizes brewers for providing a service to government.
7. The proposal could eliminate thousands of jobs within the brewing industry, and among industry suppliers.

General Offices:
2100 South 43rd Street
Milwaukee, Wisconsin 53219
414/384-7400

8. State excise taxes on beer have gone up 564% since 1951. There is no "catching up" that needs to be done when it comes to taxes on beer drinkers, a group comprised primarily of America's working men and women.

9. Longstanding federal policy has been to decrease reliance on narrowly focused, discriminatory taxes. In fact, during 1965 alone, excise taxes were completely removed from the purchasers of such luxury items as jewelry, furs and perfume. This proposal would reverse that trend.

10. The Federal Government's current budget process is resulting in cuts in a variety of domestic programs that benefit working Americans. It would indeed be unfair if this process were to be paralleled by decisions that made the tax code more regressive.

11. Indexing relieves Congress of its responsibility for tax increases.

12. Indexing promotes wasteful government spending.

13. Indexing promotes inflation.

John E Busby

Liggett Group Inc.
300 North Duke Street, Durham, N.C. 27702 (919)683-8800

STATEMENT

OF

K. v. R. DEY, JR.

PRESIDENT AND CHIEF EXECUTIVE OFFICER

LIGGETT GROUP INC.

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

WASHINGTON, D. C.

April 21, 1986

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is K. v. R. Dey, Jr. and I am President and Chief Executive Officer of Liggett Group Inc. Our primary business is Liggett & Myers Tobacco Company, located in Durham, North Carolina.

With approximately five percent of the domestic market, L&M is the smallest of the six major American cigarette manufacturers. In an intensely competitive industry, we have survived, through innovation, by pioneering generic and private-label cigarettes. In so doing, we introduced genuine price competition into the cigarette industry for virtually the first time. Today, we are the leading manufacturer of generic and private-label cigarettes in the United States.

On behalf of L&M, our employees, and our customers, I urge you not to enact a cigarette excise tax increase and not to eliminate the deductibility of excise taxes as a business expense. Because we are small and because the profit margin on generic and private-label cigarettes is slim, any cigarette excise tax increase will have a disproportionately large impact on us. We operate on a much smaller profit margin than our competitors, and thus we are less able to absorb any excise tax increase.

If an excise tax increase is linked with the elimination of the excise tax deduction, the adverse consequences for our company will be substantial. In 1985 we paid over $230 million in federal excise taxes. The inability to deduct this legitimate business expense would obviously add a huge amount to our operating costs, with a direct and negative effect on our company.

You have heard, and will no doubt continue to hear, many good reasons not to increase the tobacco excise tax. We share the views expressed by others that the tobacco excise tax is unfair because it is regressive, having the greatest impact on those least able to afford it; because it unjustifiably singles out a particular product or industry for discriminatory tax treatment; and because it distorts and dislocates the desirable system of checks and balances inherent in a free market system. We think that these arguments against excise taxes are compelling.

I simply wanted to present to you a concrete example of one company that would be significantly and adversely affected by any tobacco excise tax increase. This Committee in particular, and the Congress as a whole, needs to understand that an excise tax increase, especially if coupled with the elimination of excise tax deductibility, will have serious repercussions for businesses throughout the United States. A decision on an excise tax increase should not, and cannot legitimately, be made without taking into account these costs.

THE LION INC.
[illegible] North Pennsylvania Avenue • P. O. Box [illegible]
Wilkes-Barre, Pennsylvania [illegible]
PHONE: [illegible] AREA CODE 717

March 25, 1986

The Honorable John Heinz III
United States Senate

Dear Senator Heinz

I direct this letter to you as a member of the Senate Finance Committee in my capacity as chairman of The Pennsylvania Brewers Association and also as an individual brewer.

The Pennsylvania Brewers Association is composed of eight (8) brewers situated within the Commonwealth. Of these eight brewers, seven (7) are included in the top twenty United States brewing companies. The mere fact that this high proportion have continued to survive is testimony to the accommodating legislative climate within the Commonwealth and the allegiance of the Pennsylvania consumer.

Senator Packwood's proposed Tax Reform Plan that would deny the deductability of Excise Taxes would quickly decimate the Commonwealth brewing industry. For instance as applies to my brewery The Lion Inc. --

> In 1985 we paid $1,376,000 in Excise Taxes out of a total gross sales of $10,400,000. If Senator Packwood's proposal were to be applied, additional corporate tax of $638,000. would have to be offset by price increases.
>
> Our products are positioned in the economy priced category. Sales are price sensitive. Price adjustments required to offset the tax payment would result in a sales level inadequate to sustain operation. It is clear that this scenario would apply to the bulk of the brewing operations within the Commonwealth.

(Cont.)

Aside from the debilitating effect on the brewer, Senator Packwood's proposal is most unfair to the consumer. Under the guise of being "tax neutral" it passes the onus to the citizen group least able to absorb it.

I urge you to make every effort to find more equitable and less damaging means of meeting our country's revenue needs.

With many thanks for your consideration of this matter,
I remain

Very truly yours
THE LION INC.

Bill Smulowitz
President

INDEPENDENCE FOR INDEPENDENTS

MARYLAND INDEPENDENT TRUCKERS & DRIVERS ASS'N., INC.
BOX 9646 BALTIMORE, MARYLAND 21237

May 1, 1986

The Honorable Bob Packwood
Chairman
Committee on Finance
U. S. Senate
Washington, D.C. 20510

Dear Chairman Packwood,
We ask that this letter be entered into the record for the Committee's recent hearing on the tax reform proposal to end the deduction for excise taxes.

We oppose the elimination of the business deduction for excise taxes for several reasons. For one, we consider it to be double taxation because we would be paying tax on taxes already paid. Deductions for excise taxes are legitimate business expenses and have been so recognized for many years. Second, we consider the excise taxes paid on fuel, tires, equipment, and the heavy vehicle tax as user fees and thought that the money was to be used for highway purposes. If those taxes were no longer be deductible, the money paid in income taxes to the Government would go into the general revenue and not be used specifically for highways. We consider this an unfair proposal.

Third, to place such a heavy tax increase on an already tax burdened industry would impose a severe hardship on the trucking industry, and it would be especially disastrous to an owner-operator. To illustrate the effect on an owner-operator, we have enclosed computations based on two of our members' 1985 tax returns. They show a comparison of their tax using the deduction for excise taxes with what their tax would be if the deduction were eliminated.

We realize that the Committee is looking for ways to raise new revenue, but it is not fair to continue to add taxes upon taxes for the trucking industry and leave others untaxed. Therefore, we ask that the Committee eliminate exemptions to user fees and, if it is still necessary to raise more revenue, to be sure that any additional tax is levied across the board. We also feel that the Congress should exhaust all possibilities to save money before it looks to the taxpayer for more revenue. We do not believe it has done so.

Thank you for the opportunity to present our views for the record.

Yours truly
Rita Bontz
Rita Bontz
President, Maryland Independent
Truckers and Drivers Association

Enclosure

Illustration of taxation on independent trucker who purchased new truck during 1985: (taken from actual tax return)

Purchase price of truck $70,000	
12% excise tax	$8,400
Maryland titling tax	3,500
Federal highway use tax	550
Parts for old truck before new purchase $4,525	
12% excise	543
Fuel for traveling 90,000 miles @ 6.5 mpg	
13,846 gals @ 15 cents per gallon	2,076
Total tax (excise)	15,069

*Net Income	$28,500		
FICA tax	3,363	Net income	$28,500
Federal tax	2,819	Total tax	7,812
State tax	1,630	Income after tax	20,688
	7,812		

If the excise tax could not be claimed

*Net income	$43,509.50	(before personal exemption)	
FICA	4,672.80		
Federal tax	6,675.79	Net income	$37,569.50
State tax	2,684.86	Total tax	29,102.95
	14,033.45	Income after tax	8,456.55
Excise tax	15,069.50		**(equals 77.4% tax rate)
Total tax	29,102.95		
Income after tax			
With deduction	20,688.00		
Without deduction	14,569.50		
Extra tax payable	6,118.50		

*personal examptions and deduction averaged $6,000

** Federal income tax rate on $37,000 is only 33%, state tax rate 7.5%, FICA 11.8%, total tax rate 52.3%

Illustration of taxation on independent trucker with older truck
(computations taken from actual 1985 tax return)

Highway use tax	$550
Tires (10 tires $33.50 F.E.T per tire)	335
Fuel (90,000 miles @4½ mpg) 20,000 gals. @ 15 cts per gal.	$3,000
Parts ($9,050 @ 12%)	1,086
(excise tax)	4,971

Net income	$32,750.00
FICA	3,864.50
Federal tax	3,899.00
State tax	1,987.00
	$ 9,750.50

Net income	$32,750.00
Total tax	9,750.50
Income after tax	22,999.50

If the excise tax could not be claimed

Net income	$37,721
FICA	4,451
Federal tax	5,169
State tax	2,379
	11,999
Excise tax	4,971
Total tax	16,970

$6,000 personal exemptions & deductions

Net income	$31,721
Total tax	16,970
Income after tax	$14,751

**(equals 53.4 tax rate)

Income after tax	
With deduction	$22,999.50
Without	20,751.00
Extra tax payable	2,248.00

**Federal income tax rate on $31,000 is 25%, State tax 7.5%, FICA 11.8%, total tax rate 44.3%

Lite Miller LOWENBRAU Meister Bräu

MILLER BRANDS

May 1, 1986

Ms. Betty Scott-Boom
Committee On Finance
Room SD-219
Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Scott-Boom:

My statement in opposition to Senator Packwood's proposal to repeal the corporate deduction for excise taxes, which I request be included in the record, is as follows:

1. The price of a case of beer could increase by $1.00! Current excise tax on beer, federal and state, equals almost 80¢ per case, or, 3 1/3¢ per 12 oz bottle or can. Two-thirds of all beer is consumed by families with annual income of less than $30,000 -- America's working class!
2. Projected industry sales would decrease by 4%, or, almost 100 million cases.
3. Over 5000 jobs would be lost in the brewing, packaging, trucking and agriculture industries, many of which would be in Milwaukee, Wisconsin.

Respectfully yours,

Kirby M Lawlis

Kirby M. Lawlis
President

KML:lp

MCQUADE DISTRIBUTING CO., INC.

P. O. Box 1355, 3501 East Rosser Ave. • Bismarck, North Dakota 58502 • (701) 223-6850

April 26, 1986

Betty Scott-Boom
Committee on Finance
Room SD-219
Dirksen Senate Office Bldg.
Washington, DC 20510

TO WHOM IT MAY CONCERN:

As a beer wholesaler operating in an economically devastated area, I am vehemently opposed to Senate Finance Committee Chairman Robert Packwood's proposal to repeal the corporate deduction for excise taxes.

Any legislative measure that artificially raises the already exhorbitant taxes paid by the beer industry and my business may very well force us out of business, thereby destroying the jobs and lives of my fifteen employees.

Sincerely,

Sam W. McQuade Jr.
President

cc: Senators Mark Andrews
Quentin Burdick

MICA

MEAT IMPORTERS COUNCIL OF AMERICA, INC.
1901 NORTH FORT MYER DRIVE • ARLINGTON, VIRGINIA 22209 • (703) 522-1910

May 5, 1986

Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Hearing on Chairman Packwood's Tax Reform Proposal
as to deductibility of federal tariffs, April 21, 1986

Gentlemen:

The Meat Importers Council of America, Inc. is a trade association representing the industry which imports beef and certain other meats and meat products into the United States. Our members import most of the meats subject to the imported meat quota law. In total we import over 1.25 billion pounds (boneless weight) annually, which is about 7 to 8 percent of U.S. consumption. Our associate and affiliate members are in related businesses such as processing, shipping, trucking, etc.

We write to oppose the proposed removal of tax deductibility of tariffs on imported products. Passage of this proposal would have serious negative effects upon our importers and, therefore, on American consumers.

Most of our imported meat is currently subject to a specific rate of 2¢ per lb. under Tariff Schedules of the United States, Item 106.10. Some prepared products are subject to much higher *ad valorem* rates, such as canned corned beef at 7.5% *ad val*. under TSUS Item 107.48.

Meat importers normally operate on very small margins, often well under 1¢ per lb. on average. Thus, it is readily apparent that removal of a 2¢ per lb. deduction (not to mention the higher rates mentioned above) could substantially wipe out many importers' minimal profits.

This would be an even heavier blow in view of recent developments. All segments of the red meat industry are currently suffering unprecedented hard times, and imports are no exception. A sobering number of our importers have gone out of business over the last few years. Already staggering beef prices are being further depressed by special relief to related industries such as the "dairy buy-out" program. This summer imports of beef are expected to become subject to assessment of a new .25¢ per lb. or more under the Beef Promotion and Research Act, passed as part of the 1985 Farm Bill.

To the extent that imported beef competes with domestic lean and grass fed beef, the proposal would obviously represent a competitive advantage to domestic producers including dairy farmers who produce much of the import competitive product as a by-product of their main business and who, as mentioned, are already recipients of special preferential treatment where beef tends to suffer in consequence.

As mentioned, imports are already uniquely burdened with a strict quota. A de facto tariff increase would be especially onerous on an industry already subject to quantitative limitations. This principle, required, we believe, by both law and equity, has precedent in prior U.S. practice. For example, quota meat was exempt from President Nixon's 1971 surcharge for this reason.

We strongly urge that deductibility of duties be retained. If not, we believe it is essential to recognize that certain industries, such as those subject to quota, should retain deductibility.

Respectfully.

MEAT IMPORTERS COUNCIL
OF AMERICA, INC.

By: William C. Morrison /kf.
William C. Morrison
Executive Director

MILLER BREWING COMPANY

United States Senate Committee on Finance
SD-219 Dirksen Senate Office Building
Washington, D.C. 20510

April 21, 1986

Written Statement of
Alan G. Easton
Vice President, Corporate Affairs
Miller Brewing Company

For the Record of the
Hearing on Excise Taxes

Thank you Mr. Chairman and Members of the Committee for the opportunity to submit comments on behalf of Miller Brewing Company for the public record. The following is Miller Brewing Company's position against increasing excise taxes on consumer products in any form for the stated purposes of tax reform.

3939 WEST HIGHLAND BOULEVARD MILWAUKEE, WISCONSIN 53201-0482 • (414) 931-2000

First and foremost, Miller Brewing Company opposes each and every proposal that would increase the excise tax on any consumer product, and especially if such tax increases are masqueraded as part of a package termed tax "reform." Such hidden tax increases on even a few selected consumer goods and services would be a cruel hoax to play on those affected industries, their employees and shareholders, suppliers and distributors -- and on American consumers. The vast majority of American consumers are at long last enjoying a time when paychecks and spending power are ahead of inflation. They are at last getting a break at the gasoline pumps, and have been promised even more of the American dream in the form of tax reform and tax fairness.

Using regressive taxation methods that impact greatest on low to middle-income, working men and women, while staying tax loopholes for the wealthy, are completely contrary to the promises of tax reform made to the American people by the President, most Members of Congress and other government officials. This inflationary proposal will place the burden of tax reform on the backs of millions of working Americans to perpetuate the tax breaks afforded to a few.

We believe that the viewpoints expressed by the President, Treasury I and the 1965 U.S. Senate Committee on Finance support the elimination of all excise taxes on consumer goods and services and suggest that would be an ideal first step toward the goals of true tax reform and tax fairness.

P3

Miller Brewing Company is people -- some 11,000 employees all across the country who derive their living from the products Miller manufactures and sells. Miller is six breweries, five can plants, a glass bottle plant and a malt plant. We are located in various communities where we are well-known for our corporate good citizenship. Our culture and humanities support includes everything from concerts and art shows to community clean-ups and recycling, all paid for with earnings. We're also a network of some 750 independent distributors, employing thousands of workers, who are classic examples of small business entrepreneurship. They too are leaders in their communities, active participants in service and civic organizations that add to community life.

Currently, our products are enjoyed in each of the 50 states, the District of Columbia, Puerto Rico and the Virgin Islands. We also export our products to some 50 countries, contributing to the positive balance of payments.

Last year, Miller had an economic impact on the United States economy of almost $3 billion from salaries and wages; property, sales and other taxes; material purchases, such as American agricultural products; and from capital expenditures. For instance, we purchased more than 4 million pounds of American-grown hops worth $14.6 million; more than 191 million pounds of corn grits worth $20.7 million; and almost 24 million bushels of malting barley worth $106.7 million.

All in all, the brewing industry supports some 18,700 American farm jobs, and purchases more than $1 billion in American-grown grain. Many thousands of jobs in advertising, broadcasting, trucking, manufacturing and other industries, owe a portion of their incomes to the brewing industry.

In 1985 Miller Brewing Company collected and sent to the United States Treasury more than $332 million in federal excise taxes. We also act as tax collectors for most states and many local governments, sending some $48 million last year to state treasuries. In fact, state and local tax revenue from beer has increased by 564 percent since 1951. Advocating an increase in the federal excise tax on beer completely ignores the fiscal policy of state and many local governments. Excise taxes on alcohol beverages provide significant revenue for state and many local governments as compared with U.S. Treasury revenue from federal excise taxes. Thirteen states tax beer at higher rates than the $9.00/barrel federal excise tax.

Mr. Chairman and Members of the Committee, the point is that while Miller is a major company in the beer business, it is not a "thing" to be manipulated and taxed to death. We are a corporation who pay taxes, we are employees who pay taxes, we are distributors who pay taxes, we are important sources of revenue for states and some local governments, and we purchase many goods and services such as grain and hops from American farmers who pay taxes. We are one of America's surviving domestic industries, although we face increasing foreign competition from companies who receive favorable import-tax treatment, allowing them to easily price-compete with us.

Most important, we produce a product that is enjoyed by 80 million consumers, mostly middle and lower-income, blue-collar working men and women who already shoulder a disproportionate share of the tax burden, especially if you compare what they pay to huge profitable corporations and wealthy individuals who pay little or nothing. Increasing the excise tax on beer in any form, whether directly, by disallowing income tax deductions or by indexing the tax to prices, will result in our being forced to pass the additional tax in the form of price increases on to consumers. Some have suggested that manufacturers should absorb or partially absorb any excise tax increase. The economics of the highly-competitive beer business simply do not allow for any absorption of excise tax increases -- or other business costs.

In the beer business, as with most consumer products, it's a common economic fact that when prices increase, sales decrease. And when you lose sales, you are forced to cut back on the number of employees; you are forced to cut back on the goods and services you purchase such as the American-grown grain and hops used to make beer. You also have to cut-back on philanthropic endeavors and other non-essential expenses. The bottom line is, Miller Brewing Company and the American brewing industry already pay more than their fair share in taxes of all kinds. And it is ultimately the already over-taxed consumer who pays the excise tax bill.

P6

The federal excise tax on beer has historically been a temporary, emergency war tax imposed at times when almost all Americans were asked to shoulder the costs of the Civil War, World Wars I & II and the Korean War. To say that this tax has not kept up with inflation ignores history. In fact, in the absence of declared war, this tax should rightfully be removed to fulfill the promises made to the American people when Congress imposed this "temporary, emergency" tax. Other emergency taxes such as the "luxury taxes" on jewelry, perfume and furs, affecting mostly wealthy individuals, have been repealed. But today, the beer industry -- and beer consumers -- are still looked upon as some gigantic keg of money that can be tapped over and over again. That simply is not so. The highly competitive beer business is in a decline, not a growth stage. Further taxation, whether through straight increases or disallowing the deductibility will drive it into steeper decline. Breweries that go out of business, and employees who lose their jobs pay no taxes and become a drain on government!

Any short-term tax breaks for consumers under a tax plan that includes raising excise taxes on consumer goods will be quickly devoured by price rises in so many of the goods and services people need and enjoy -- and by dislocation and unemployment in the affected industries.

Using increased excise taxes to engineer social reforms aimed at those who choose to consume alcohol beverages is counter to all historical taxation policies, is poor economic policy and violates principles of fairness and equal treatment for all as promised by the Constitution of the United States.

The prohibitionist social engineers have failed to achieve their "control" goals elsewhere, and now seek to dictate tax policy in order to punish all alcohol beverage consumers. Using federal tax powers to reduce and restrict the availability of beer to legal consumers is highly discriminatory and grossly unfair. More than 50 years ago, Prohibition taught us that problem drinkers and alcoholics will drink at any price. Recently, noted medical and psychological experts have stated time and time again that increased taxation to increase alcohol beverage prices will have little or no effect on problem drinking. Consumer choices should be determined by the market place, and not through government-manipulated prices.

Even a "slight" increase in excise taxes ignores the traditional economics of wholesaler and retailer mark-ups. For every cent of new tax collected by the government, the resulting artificial cost increase to consumers exceeds it by several times.

By adopting "equalization" as public policy (increasing the excise taxes on beer and wine to the level of hard liquor based on alcohol content) Congress would be endorsing a bogus theory put before it by a foreign-owned company to boost lagging hard liquor sales. For more than 200 years, alcohol beverage regulators and taxmakers in this country and abroad have treated beer, wine and hard liquor different because of the different ways each is consumed and the difference in each's effect on the human body. To say that a beer is the same as a martini -- and to treat each the same for purposes of taxation -- is both incorrect and dangerous. Public policy should be based on facts, not misleading marketing claims. Further, because beer and wine each vary widely in alcohol content from brand to brand and variety to variety, attempts to regulate and enforce an "equivalent" tax policy would be an administrative nightmare if not downright impossible. The proposal to equalize beer and wine excise taxes to the level of hard liquor should be immediately rejected for what it is -- a misleading marketing ploy to sell more hard liquor.

Increasing excise taxes on consumer products will mean:

- o Higher prices for those consumers least able to afford them;
- o Loss of jobs in directly and indirectly affected industries;
- o Loss of revenue to local and state governments and the federal government as sales decline;
- o a departure from traditional tax policy in that the increases would be inequitable, inflationary and harmful to the economy as a whole.

In conclusion, I urge the Chairman and Members of the Committee to reject any proposal to raise excise taxes on any consumer goods or services. Rather, I urge you to listen to those respected economists who say that excise taxes are the poorest form of taxation because they are hidden and regressive, and to repeal all excise taxes currently levied on consumer products.

Miller Brewing Company strongly supports the principles of tax reform if such reform eliminates preferred tax treatment for some tax payers, distributes the tax burden more equitably among all taxpayers and makes the system more neutral with regard to business decisions.

There is revenue available to achieve tax reform -- from those wealthy individuals who pay little or no taxes; from those industrial giants with profits in the millions or billions who pay little or nothing; and from those alcohol beverage importers who received a $165 million tax loophole from the Trade Agreements Act of 1979. Tax "reform" must be synonymous with tax "fairness."

The worthy goals of tax reform should promote economic growth for all, not economic chaos for low and middle-income consumers.

Thank you.

-gpw-

M

MOTOR VEHICLE MANUFACTURERS ASSOCIATION
of the United States, Inc

1620 EYE STREET, N.W. SUITE 1000 • WASHINGTON, D.C. 20006 • AREA 202-862-3900

ROGER B. SMITH, *Chairman*
THOMAS H. HANNA, *President and Chief Executive Officer*

May 5, 1986

The Honorable Bob Packwood
Chairman
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Dear Senator Packwood:

The Motor Vehicle Manufacturers Association of the U.S. Inc. (MVMA)* appreciates the opportunity to submit comments for the record of the Senate Finance Committee's April 21, 1986 hearing on the "Deductibility of Federal Excise Taxes and Tariffs" provisions of Tax Reform Proposals in Connection with the Senate Finance Committee Markup. MVMA is opposed to the "Deductibility of Federal Excise Taxes and Tariffs" provision for a number of reasons:

- The section of the provision which states that "these taxes and tariffs would be nondeductible for income tax purposes" represents an unjustified increase in excise taxes by a minimum of 54 percent.

- The provision is contrary to long-standing accounting and tax policy principles regarding the costs incurred by business in producing income. Those principles, now embodied in Section 162 of the Internal Revenue Code of 1954 state, "There shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...." Clearly, under the income tax concept, Federal excise taxes and tariffs are a deductible cost of goods sold or

---

* MVMA represents U.S. automobile, truck and bus manufacturers producing more than 98 percent of all domestic motor vehicles. MVMA members are: American Motors Corporation; Chrysler Corporation; Ford Motor Company; General Motors Corporation; Honda of America Mfg., Inc.; LTV Aerospace & Defense Company, AM General Division; M.A.N. Truck & Bus Corporation; Navistar International Corporation; PACCAR Inc; Volkswagen of America, Inc.; and Volvo North America Corporation.

TLX NO. 705211 AUTOMAKERS WSH UD

an "ordinary and necessary" expense for business. In fact, in contrast to certain other expenses over which businesses have some control, e.g., wages, businesses have no control over the excise tax or tariff costs imposed on them.

- Denying the deductibility of Federal excise taxes in computing a business' taxable income would also have a serious adverse competitive impact on certain industries. Highway-users, particularly the trucking industry, already bear a disproportionate large share of the burden of excise taxes. Other industries, including competitors to highway-users, incur a much lesser burden. Nowhere is this competitive distortion more apparent than in the disparate treatment of trucking firms (which pay excise taxes on their vehicles, tires and the fuel they consume) and railroads (which pay excise taxes on neither equipment nor fuel).

- The proposed anti-avoidance rule section of the provision would require businesses to pay income tax at the top corporate rate on taxable income at least equal to their excise tax liabilities. This would be irrespective of the actual amounts of their net incomes. Thus, a company with a net operating loss would be required to pay on a phantom taxable income equal to the excise tax liability. This section could set a precedent for assessing tax liability without any reference to economic realities.

MVMA believes that the proposed "Deductibility of Federal Excise Taxes and Tariffs" provision would be a step backward in tax policy. We urge that they be deleted from the tax reform proposals.

Very truly yours,

Thomas H. Hanna

THH/mve

montana motor carriers association inc.

B G HAVDAHL, EXECUTIVE VICE PRESIDENT
P O BOX 1714, HELENA, MONTANA 59624
TELEPHONE AREA CODE 406 442-6600

April 18, 1986

The Honorable Max Baucus
United States Senate
Washington, DC 20510

Dear Max:

The Montana Motor Carriers Association herewith submits the following written comments with respect to Tax Reform Legislation now pending in the Senate Committee on Finance.

The Montana Motor Carriers Association represents some 350 motor carrier members and 125 supplier members and supports tax reform based on rate reduction, reasonable cost recovery, and base broadening. Senator Packwood's proposal has one positive element, a statutory corporate rate of 35%, but it contains several items (discussed below) that negate the spirit of tax reform.

MMCA opposes the nondeductibility of excise taxes. The Packwood plan would end the deductibility of all federal excise taxes and tariffs, and apparently would require businesses that remit excises to the government to include those amounts in income. In effect, anyone collecting and remitting excises and tariffs would have to pay a new tax on these taxes, at a 35% rate, with no offsets for losses or credits. Trucking companies would be directly affected with respect to the heavy vehicle use tax and diesel purchased in bulk. They would also see increases in retail prices of trucks, trailers, parts, tires, and fuel, since manufacturers or dealers of these products would pass on their tax increases. Directly or through product prices, truck operators pay $6.8 billion in federal excise taxes. (The for-hire trucking industry pays nearly half this sum, $3.3 billion, and would be faced with an income tax increase of more than 40%.)

Depreciation. Currently tractors, straight trucks under 13,000 pounds, and cars receive three-year writeoffs for depreciation, which is appropriate. The Packwood plan changes this to five years, which would hurt cash flow. Straight trucks over 13,000 pounds would remain in the five-year class. Structures, such as terminals, garages, and offices, would be moved from the current 19-year accelerated class to a 30-year straight-line writeoff. These changes would apply for assets placed in service after 1986. MMCA believes current lives for trucking assets should be retained. The Packwood proposal includes two potentially favorable elements: Indexing of depreciation if inflation is between 2% and 8%, and expensing of up to $50,000 of investments for firms investing less than $250,000 altogether per year.

Indexing of fuel taxes. Federal fuel taxes would be adjusted upward under the Packwood plan when prices rise, but would not be allowed to fall below current levels. No amounts or mechanisms are specified. Current fuel tax levels should remain as is,...along with earmarking of receipts to the Highway Trust Fund. Increased rates are not warranted, nor should funds be diverted from the Trust Fund to pay for tax reform, deficit reduction, or other purposes.

MEMBER ATA
REPRESENTING THE TRUCKING INDUSTRY IN MONTANA

Corporate rate. The top corporate rate would be set at 35%, as of July 1, 1987. This is the most favorable part of the plan, but the effective date is one year later than in the House bill and six months later than most other changes in the Packwood plan. MMCA favors the largest and earliest possible rate reduction.

Minimum tax. The Packwood proposal includes an alternative minimum tax for corporations and individuals at a 20% rate. The base would include accelerated depreciation plus one-half of the excess of book income over taxable income. These elements would make the minimum tax expensive for some trucking firms, although the rate is preferable to the 25% rate in the House bill.

Investment tax credit. The Packwood proposal would repeal ITC for investments placed in service on or after March 1, 1986. No ITC carryover could be claimed in 1987. In 1988, taxpayers could "cash in" all pre-1987 ITC carryovers at a rate of 70 cents on the dollar. No further carryovers would be permitted. This would help companies that do not expect to claim carryovers for many years but hurt ones that expect to use all carryovers in the next few years. This provision is intended to be revenue-neutral; if, MMCA has no position on it at this time.

Many thanks for your consideration.

Sincerely,

BG Havdahl

B. G. HAVDAHL
Executive Vice President

BGH:ap
cc: Ms. Betty Scott-Boom ✓

TESTIMONY PRESENTED BY

THE NATIONAL BEER WHOLESALERS' ASSOCIATION INC.

TO THE COMMITTEE ON FINANCE
U.S. SENATE

APRIL 21, 1986

The following testimony is submitted for the record by the National Beer Wholesalers' Association to register opposition to several issues raised in the tax proposal prepared by the Senate Finance Committee staff, which would raise or have the effect of raising the excise taxes on malt beverages and other alcohol beverage products.

The National Beer Wholesalers' Association is comprised of over 2,000 beer wholesalers in the United States who market over 90% of the malt beverage products sold.

This association and the members it represents are opposed specifically to three of the items contained in the staff draft which is currently under consideration by the Senate Finance Committee. They are: (1) The proposal to eliminate the deductibility of federal excise taxes; (2) The proposal to index federal excise taxes to producer prices; and (3) To raise the federal excise tax on wine up to an alcohol equivalency level with that of beer. We will take these items in order

Elimination of the deductibility of federal excise taxes

Eliminating the deductibility of federal excise tax is nothing more than a hidden tax increase on the American consumer on products required to pay such a tax. More importantly, because excise taxes are consumption taxes they would fall most heavily on those with the least ability to pay. Two-thirds of all beer consumed in the United States is purchased by families with gross incomes of $30,000 or less. More specifically, the United States Department of Labor estimates that family households with incomes in the $20-25,000 range spend more than half of their alcohol beverage budget on beer. This is compared with family income of more than $50,000 who spend slightly less than 25% of their alcohol beverage budgets on beer. Because excise taxes are such a regressive tax, the Packwood proposal (staff draft) would reduce the benefit for the lower income family.

deSeve economics in a recent study has reported:

> "For individual taxpayers in the aggregate the excise tax on beer provisions would wipe out almost half the income tax reduction promised by this plan. The effect by income class would be very uneven. Those in the highest bracket would lose in this way only 6% of their income tax reduction, where as those in the lowest bracket would lose more than 60% of theirs."

We find irony in the fact that excise taxes have been removed from such luxury items as furs, jewels, luggage and perfume; yet, excise taxes remain, and are proposed to increase, on consumer items, which are purchased disproportionally by working men and women.

Excise taxes have a tendency to remove the burden of responsibility for taxing the public from the Members of Congress who should be held accountable for any tax increases. Consumers do not know what percentage a profit which has included in its price a federal excise tax.

The Beer Institute has estimated that the price increases necessitated by the current proposal would reduce brewing industry sales by roughly 3% during the first year following enactment. This non-recoverable loss would eliminate roughly 75 million cases of product from the industry's total volume. Were employment to drop by the same percentage as industry sales nearly 6,000 brewing industry positions would be lost. That impact would fall most heavily on the beer wholesaler whose diminishing operating margin will be further reduced. Such a reduction in operating margin would force a number of smaller beer wholesalers to go out of business, thus exasperating the industry consolidation, which is ongoing.

Indexing Excise Taxes

The second of the Packwood proposals which NBWA opposes would index the federal excise tax on alcohol, tobacco and gasoline to some sort of producer price increase. The Finance Committee staff has yet to provide details of this proposal.

It is interesting to note that indexing was imposed in Canada in 1980 on the brewing industry and was forced to be abandoned five years later. During that five year period (1980-1985) beer prices tracked above the Consumer Price Index. During the five years prior (1975-1980) to the initiation of indexing, the reverse was true.

Indexing is most insidious in that it allows Congressional Representatives to pass the buck in terms of responsibility they have to their constituents in accounting for their actions. In proposals to increase taxes further, indexing guarantees automatic revenue growth. This dispite any indication as to whether or not such revenue growth is necessary. In this era of budget deficits, restraint is called for. Indexing automatically eliminates the need for fiscal restraint.

Excise Tax Increase on Wine

The proposal to raise the federal excise tax to an alcohol equivalency level of beer flies in the face of historical public policy. Every country in the world, including the United States, has traditionally taxed alcohol products based upon their usage, and recognizes that the three main alcohol products are socially different. While the beer industry would not be directly affected by the proposal, NBWA and its membership is inalterably opposed to any and all forms of higher excise taxes.

In summary we believe that indexing, the elimination of deductibility and the increase on the excise tax on wine are simply back door financing mechanisms, that really fool no one but the taxpayer and therefore the consumer. We believe that Members of Congress are and should be willing to be held accountable for votes cast on the questions of new taxes and higher taxes.

We trust that members of this committee generally are aware of the breadth of the beer industry involvement in the American way of life and the U.S. economy. Let us cite but a few examples:

- The beer industry employs 189,500 people, who, in turn, pay taxes and buy millions of dollars worth of goods and services from other American industries.

- The beer industry pays over $4 billion in federal, state, and local taxes, which support government programs ranging from humanitarian services for the handicapped to law enforcement and road construction.

- The economic strength of the beer industry is a catalyst for other areas of the economy. It creates hundreds of thousands of jobs at the retail and manufacturing levels.

- At a time of great concern about the fate of the American farmer, the beer industry buys $900 million worth of agricultural products per year.

- The industry is a major buyer of aluminum, glass, trucks, and packaging products.

- The industry poses no threat to the environment--all of its by-products are used in other industries, such as yeast for making bread and feedstuffs for cattle.

- Members of the beer industry have consistently been at the forefront of community service through the sponsorship of youth athletic programs, the arts and education.

- And, perhaps most important, our industry has long been associated with hospitality and sociability. Since the dawn of the Republic--when both George Washington and Thomas Jefferson were brewers--the beer industry has been an important and respected part of the American social fabric.

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NATIONAL ASSOCIATION OF TOBACCO DISTRIBUTORS NATD

Chairman of the Board
Leon Shahun Jr
Samelson-Leon Co. Inc

President
Nick Karakas
Marcus Distributors, Inc

Secretary
Peter Straus
The Seneca Company

Treasurer
Jay Martin
Capital Cigar & Tobacco Co

Executive Director
Terry J. Burns

May 1, 1986

Senator Bob Packwood, Chairman
Senate Finance Committee
U.S. Senate
Room SD-219
Washington, D.C. 20510

Dear Mr. Chairman:

This letter contains the comments of the National Association of Tobacco Distributors (NATD) regarding certain provisions of your tax reform proposal relating to excise taxes. We request that this letter be made part of the April 21, 1986 hearing record regarding excise taxes. Specifically, we oppose the non-deductibility of federal excise taxes and the increase of tobacco excise tax rates based on prices.

The NATD represents over 570 small business wholesaler-distributor members, with over 740 distribution outlets. Our Association also represents 230 manufacturer and supplier associate members whose 12,000 salesmen canvass and supply almost 1.5 million retail outlets selling tobacco products across the United States. Our industry markets goods with an estimated annual wholesale value of over $16 billion dollars.

I appeared as a witness before the Senate Finance Committee last September 10, 1985 regarding the issue of cigarette excise taxes. It seems that every time the Committee searches for additional federal revenue, the tobacco industry is targeted for excise tax increases. This occurs despite the full Senate's rejection of cigarette excise tax increases. On behalf of the NATD, I would like to explain our policy position and rationale regarding opposition to the excise tax proposals.

The Full Senate Opposes Cigarette Excise Tax Increases

On October 22, 1985 Senators John Chafee (R-RI) and George Mitchell (D-ME) introduced two amendments on the Senate floor to S. 1730, the Budget Reconciliation Bill, seeking to raise the cigarette federal excise tax from 16 cents per pack to 24 cents, or to 20 cents, respectively. Both amendments failed in two separate votes; Senator Chafee's amendment by 66 to 30 and Senator Mitchell's vote 66 to 25. The Senate has also supported the rentention of the present 16 cents per pack rate, by passing Public Law 99-190, the Omnibus Budget Reconciliation Act. This law makes the 16-cent rate permanent.

Tobacco Excise Taxes Are Regressive

It is unfair to place the burden of deficit reduction on the cigarette excise tax. This tax is regressive because its impact is proportionally greater on persons with low and moderate incomes. Excise taxes are consumption taxes which are passed through to the consumer. Regressive taxes should not be utilized as a means to eliminate federal budget deficits.

Cigarette Smuggling Will Increase

There is a real danger that higher cigarette excise taxes will increase the incentive regarding interstate cigarette smuggling. As the price of the product increases due to excise taxes, there is a greater incentive for organized crime to engage in various contraband cigarette schemes, which will likely result in higher law enforcement costs as well as social problems produced by crime. While one cause of cigarette smuggling is the difference in state and local cigarette tax rates, from state to state, and from community to community, the federal cigarette excise tax rate also significantly affects cigarette contraband problem. This is because the federal tax raises the overall value of the commodity and therefore increases the "return" on such crimes as hijacking cigarette shipments from trucks and other carriers.

Small Retail Stores Will Sustain A Substantial Economic Loss

Under the proposal to increase the cigarette excise tax, it is likely that the small retailer would be severly hurt. For example, convenience stores depend on sales of cigarettes for a direct and substantial portion of their gross revenues, as much as 20%. In addition, sales of cigarettes are also important as an attraction convenience store to customers, who then also purchase other grocery items, and therefore cigarettes indirectly generate even more gross revenue for the retailer. In an industry which operates on a thin profit margin, the impact of the proposed cigarette excise tax increase on gross sales, employment, and profits may be substantial. If one of the budget balancing objectives is to foster an expanded economy, then a serious decline in sales, producing a rise in unemployment in this sector, is counter-productive. It is estimated that at retail, the initial impact on the consumer could be an increase of about $2.50 per carton of cigarettes.

Companies Should Not Be Penalized

Federal excise taxes are a legitimate cost of doing business, and therefore should be deductable for federal income tax purposes. Such excise taxes certainly should not be construed to impute "income" to the companies that collect them. Even though excise taxes are ultimately paid by the consumer, they are collected by the manufacturers and remitted directly to the federal government in full and on time; and thus these "private sector tax collectors" should not be "punished" for doing a good job. Excise taxes are generally collected at the company level to minimize the difficulty and complexity which would result from trying to collect them from consumers. The nondeductibility proposal would penalize those companies which are required to act as collectors on behalf of the government.

Tax On Cigarettes Based on Price Is Confusing

Your proposal includes an excise tax on cigarette products based on price. This imposition of an excise tax is confusing to the taxpayer and the government tax collectors. Will the tax be imposed on the retail price, the wholesale price or the manufacturer's price? Who will police such a provision? How will it affect new products? We believe this proposal is unworkable in that it will cause more enforcement problems, and disruptions in the free movement of products and prices in the economy, than does the existing system of firmly-established cigarette excise tax rates.

In summary, the NATD urges the Committee to reject the proposals regarding nondeductibility of excise taxes and increasing the excise tax rate for cigarettes based on price.

Sincerely,

Terry Burns

STATEMENT OF

RONALD L. ZIEGLER

PRESIDENT

NATIONAL ASSOCIATION OF TRUCK STOP OPERATORS

Before The

UNITED STATES SENATE COMMITTEE ON FINANCE

Regarding

EXCISE TAX NONDEDUCTABILITY AND INDEXING PROVISIONS OF PROPOSED TAX REFORM

Washington, D. C.

April 21, 1986

BEFORE THE

UNITED STATES SENATE

Statement on Behalf of the

NATIONAL ASSOCIATION OF TRUCK STOP OPERATORS

HEARING ON

EXCISE TAX AND TARIFF CHANGES

PROPOSED AS PART OF TAX REFORM

April 21, 1986

I am Ronald L. Ziegler, President of the National Association of Truck Stop Operators, Inc. (NATSO). NATSO is the national organization representing the truck stop industry in the United States. NATSO's 800 member facilities, located primarily on the Interstate and Federal-Aid Highway Systems, comprise the major segment of an annual $20 billion industry. In addition to restaurant, motel, garage, and convenience and general merchandise store operations, truck stop operators in 1985 were responsible for the retail marketing of over 10 billion gallons of diesel fuel and approximately 2 billion gallons of gasoline. Over two-thirds of all diesel fuel sold to the commercial trucking industry is sold by truck stop operators.

Clearly, then, the truck stop industry has a critical interest in the excise tax proposal being considered by the Committee on Finance. NATSO commends the Chairman for holding this hearing and we appreciate the opportunity to address the grave concerns truck stop operators have about this proposal.

SUMMARY

NATSO contends that the proposal to deny business taxpayers the deduction for excise taxes on motor fuels and to index future excise taxes is inequitable. It is incomprehensible to me that such a proposal could come under serious study and we strongly oppose its enactment.

Essentially, what we're talking about here, in a sense, is a tax on taxes collected. In large measure, truck stop operators traditionally have functioned as collectors of these taxes for the federal government. NATSO submits that this process is not a loophole in the current tax code; truck stop taxpayers do not receive these monies as income and the amounts collected are remitted every two weeks to the Internal Revenue Service. Thus, forcing businesses to treat motor fuels taxes as income with no corresponding deduction places an unwarranted tax burden on the truck stop operator.

It is a tax burden that many truck stop marketers will not be able to bear. NATSO estimates that its average member in 1985 sold approximately 5 million gallons of motor fuels (representing 90 percent diesel and 10 percent gasoline) and had a before-tax profit of approximately $50,000. Let me clearly identify for the Committee that this figure would mean that such an average truck stop today pays corporate income tax in the 30 or 18 percent tax bracket. The proposed lowering of the maximum corporate rate to 35 percent will have no effect on the average truck stop operator. Even those truck stops which are in the 40 and 46 percent brackets today will not benefit by any tax reform package that contains this proposal.

Under the new proposal, assuming that all excise taxes on diesel and gasoline are collected and remitted by the truck stop, an average truck stop operator will have new taxable income of $720,000 and a new additional tax liability (at the proposed maximum corporate tax rate) of $252,000 — more than five times its current pre-tax profit!

For the truck stop industry as a whole, the proposed elimination of excise tax deductibility would cost operators $525 million on diesel excise taxes and another $63 million on gasoline excise taxes. Over the five years, then, the truck stop industry's share of this so-called "tax reform" would be $2.94 billion. If this is reform, then the truck stop industry cannot afford it.

I can state unequivocally, Mr. Chairman, that the amount of this burden will devastate truck stop operators and will debilitate this important segment of the fuel marketing chain. It will result in some operators going out of business. This proposal asks truck stop operators to pay a tax on phantom income. It will force every truck stop operator to seek to pass along this new tax liability to customers in the form of higher prices for fuel. As such, the elimination of excise tax deductibility for truck stop operators will create a regressive tax increase on their customers — independent owner-operators, trucking fleet operators (both for-hire and private), bus operators and the motoring public. Finally, it will create competitive imbalances in the truck stop market place because some truck stop operators may absorb part of the new tax.

NATSO submits that these effects are not mutually exclusive, nor do they present an inconsistent position to this Committee. There will be different short-run and long-term impacts, as truck stop operators react to the additional tax liability imposed by non-deductibility.

Where competition or fixed-price contracts for fuel exist, it may be impossible to pass along any or all of the cost of the new taxes. This Committee should understand, Mr. Chairman, that the truck stop industry is highly competitive and that a few cents differential in prices at the pump can create major shifts in fuel buying patterns. Since truck drivers can travel at least 400 miles on a tank of fuel, an individual truck stop's competition in literally hundreds of miles up and down the highway. If one or more competing business decides to absorb the additional tax liability without raising prices (or only partially recovering the added liability), other truck stops must follow suit or risk losing substantial business because their fuel is higher prices. This is truly a Hobson's choice — forcing the truck stop operator to elect the way to jeopardize its very existence.

Describing this dilemma is not idle speculation on NATSO's part. Some corporations exist in the truck stop industry that have the ability (because of size, financial strength and/or relationship to refiners or wholesalers) to sustain a policy of absorbing some or all of the increased price due to the non-deductibility of excise taxes. If that absorptive marketing concept is employed, even for its short-run impact, an imbalance will be created in the truck stop market which strikes at the very core of our industry — the vitality of individual owners or operators of full service truck stops.

In short, the denial of excise tax deductibility for truck stop operators will cause chaos in the industry and massive disruption in diesel fuel marketing and related trucking and bus industries who are our customers. Not only is the proposal seriously flawed because it fails to comprehend the complex and sensitive motor fuels tax collection process that is in place, but because it actually will dismantle that structure. Truck stop operators are performing a service for the IRS and the federal government by collecting these excise taxes and this proposal would destroy many of those businesses. Accordingly, current law should be retained because, for truck stop operators who collect and remit them, motor fuel excise taxes are a legitimate deduction to offset that part of the cost of fuel paid to the government. That money is not income nor does it represent one dime of profit to the businesses that collect it.

CURRENT LAW REPRESENTS A COMPLEX TAX STRUCTURE THAT CANNOT BE CHANGED WITHOUT ADDRESSING NUMEROUS EFFECTS

Under the current tax code, as amended by Public Law 98-369 (effective August 1, 1984), the federal excise tax on diesel fuel for highway use is 15 cents per gallon. 26 U.S.C. § 4041(a)(1). However, the excise tax on gasoline remained at 9 cents per gallon. Although the law permits gasoline marketers to elect whether to buy fuel tax-paid or ex-tax (so that they may collect and remit the tax), retail diesel fuel marketers have no such election. They must collect and remit the diesel excise taxes to the federal government. This is the position of most truck stop operators (except for a small minority who may qualify as diesel fuel wholesalers). Since the majority of truck stop operators also elect to collect and remit gasoline taxes, they are in the situation where every cent of excise tax on the fuel they sell is collected by them during the year and would be taxed as income under the proposal.

Current law also contains numerous exemptions or partial exemptions for certain end users of gasoline and diesel fuel that are customers of truck stop operators and other marketers. These tax exempt categories include state governments, some local governmental entities, local school districts, the National Guard, and public mass transit. Others, such as private intercity bus companies and taxi cabs only pay part of these taxes. Farmers are exempt or not depending on whether the fuel is used on the farm for farming purposes. Even truck drivers are exempt from the diesel excise tax on fuel for non-highway use, such as for use in refrigeration units.

NATSO contends that the non-deductibility of excise taxes will result in all of these groups paying more for fuel and thereby indirectly paying excise taxes. When the truck stop or marketer increases the price of fuel at the pump to offset added income taxes, that increase will not be characterized as an excise tax at all. This Committee should recognize that the proposal will have serious consequences on these end users. These effects have not been considered at all in the analysis of what impacts arise under non-deductibility.

The current tax code situation is important for another reason. It enables truck stop operators to maintain better cashflows in their businesses, since they have the use of collected excise taxes for up to 13 days until those sums are remitted to the IRS. Although the float yields relatively small interest income, buying fuel without paying the tax allows the truck stop to purchase more fuel for the same price of tax-paid fuel. Besides these significant business benefits, there are others that encourage truck stops to collect and remit excise taxes. For these reasons, NATSO strongly supports continuation of the collect and remit process.

However, if this Committee ultimately finds any merit to making excise taxes non-deductible, NATSO requests that the Committee then adopt the language passed by the House of Representatives in H. R. 3838 that creates the same election for collecting diesel excise taxes as currently exists for gasoline taxes. On balance, NATSO believes most truck stops would choose to forego the right to collect and remit diesel taxes and instead pay them to the supplier or manufacturer.

Finally, one last point concerning the current law should be made, which NATSO urges the Finance Committee to consider carefully. NATSO recognizes that the Highway Trust Fund, into which all fuel excise taxes are placed, is part of the federal unified budget. However, it is out of this fund that Congress has historically preserved and strengthened the highway infrastructure. Consequently, then, NATSO feels strongly that new revenues, under either the guise of tax reform or as part of budget deficit reduction, should not be diverted out of the HTF. Moreover, our customers in the trucking industry, who already pay extremely high taxes and must compete with the railroads that pay no excise taxes, should not bear alone the indirect costs of increased fuel taxes under this proposal.* Instead, the Committee should recognize that it must broaden the revenue base by requiring all transportation sectors, especially the railroads, to pay their fair share. Only in this way can tax reform be achieved on a rational basis, without arbitrarily selecting fuel marketers and highway transportation users to absorb billions of dollars of added taxes.

THE TRUCK STOP INDUSTRY WILL BE ADVERSELY AFFECTED BY THE PROPOSAL

Earlier, I made the point that many truck stop operators, those at or below the average gallonage figures for the industry, would suffer a financial catastrophe if fuel excise taxes are treated as income to those who collect them, with no offsetting deduction. I also stated that even higher volume truck stops and those who are in the 40 and 46 percent income tax brackets today would be harmed. Let me demonstrate this position graphically.

Example No. 1: One of NATSO's best run individually-owned truck stops had gross sales (all operations, not just fuel) of $10,844,593 in fiscal year 1985. The operator collected and remitted excise taxes of $1,073,478, or 9.9 percent of the total sales. On these gross sales, the truck stop had taxable income of $298,541 (2.75 percent of gross) and paid corporate income tax of $111,152. The operator was in the 46 percent bracket and paid an effective rate of 37.23 percent. The company's after tax profit was $187,389.

If the non-deductibility proposal had been in effect, however, this truck stop operator would have had a taxable income of $1,372,019. At the proposed maximum corporate tax rate of 35 percent, its new tax liability would have been $480,206, resulting in an after-tax loss of $181,665.

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* To the extent that motor carriers purchase diesel fuel in bulk, store it and pay the excise tax as the fuel is used for highway operations, they are "users" who are liable for the "income" taxes under the new non-deductibility proposal.

Example No. 2: A slightly smaller volume truck stop operator, an independent marketer owning two facilities, sold approximately 7.5 million gallons of diesel fuel in fiscal 1985 and collected and remitted $1,121,810 in excise taxes. This truck stop business had a taxable income of approximately $227,000, with liability of about $85,920 calculated at the 46 percent bracket. Again, if the new excise tax income proposal were in effect, this truck stop operator would have had taxable income of $1,348,810 and paid taxes of $472,083. Clearly, the change in profit picture is serious and places the truck stop, as collector of excise taxes, in an impossible position unless the entire amount is recovered by increased fuel prices.

Example No. 3: Working down to the average gallonage figures, another truck stop operator who has one of the largest volume facilities in his state sold 6.4 million gallons of diesel product in fiscal year 1985. The corporation's taxable income was approximately $80,000, on which it paid over $15,000 in tax at the 40 percent bracket. Under the proposal, adding the $960,000 in excise tax income from the 6.4 million gallons sold would yield an additional tax liability of $336,000. Thus, this NATSO member is being asked to pay more than 20 times his original tax bill.

What these examples serve to illustrate is that every truck stop operator in the country will be devastated financially by making excise taxes into income. The only way that the truck stop industry should fairly be required to accept this burden would be for operators to have the right to keep all excise taxes collected! Such monies would then truly be income, not some thinly-veiled attempt to shift these fuel excise taxes from a "cost of doing business."

However, the proposal being considered by the Committee in no way relieves truck stop operators from the obligation to remit the fuel excise taxes they collect. Thus, it appears to us that small businesses like ours are going to shoulder the burden of creating a "revenue neutral" tax reform bill.

The truck stop industry cannot possible afford to absorb new taxes of nearly $600 million each year. There are various reasons why the truck stop industry suffers a particularly heavy impact under the proposal. The primary difficulty is the high amount of the excise tax in relation to the price of fuel at the pump. At today's reduced retail price of fuel, the diesel excise tax constitutes a percentage approaching 20 percent (as retail prices fall towards 80 cents per gallon).* Even if prices rebound, the amount of these excise taxes would still be proportionately higher than similar excise taxes on other goods and services. These federal excise taxes are often four or five times as much as the net profit margin on fuel. Accordingly, the Committee should expect that truck stop operators would be more substantially and adversely affected by this proposal than other industries.

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*For gasoline, the percentage is generally around 10. As the Committee undoubtedly realizes, every state also has substantial fuel excise taxes that are imposed and that truck stop operators are also collecting and remitting to those jurisdictions.

Compounding this impact is the fragile financial condition and generally high effective tax rate being experienced by the trucking industry. Since the majority of truck stop customers are themselves affected by the regressive nature of the proposal (the effect is not only on fuel, but on tractors, trailers, tires, and other user fees), it is hard to imagine a more compelling reason to reject this result. I reiterate my contention that some truck stops will not be able to absorb the effect of this proposal. Nevertheless, the best guess that NATSO can make is that the price of diesel fuel will rise between 8 and 10 cents per gallon, and the price of gasoline will rise at least 5 cents per gallon, if excise taxes are treated as income.

These figures, however, may be subject to further increases. NATSO is very concerned that some refiners, who will be liable for payment of their own manufacturer's excise tax "income", will decide to spread their liability over the whole range of products they sell. If so, there is a distinct possibility that the price of diesel fuel will increase from the refiner/supplier, even though oil companies are responsible for almost no excise taxes on that product. This would double the penalty on end users, who would pay indirectly for the excise tax income effect on truck stops and their suppliers.

Because of these practical implications, as well as the real likelihood that taxing excise taxes as income will be challenged on constitutional grounds, NATSO earnestly submits that the current tax code treats truck stop operators more fairly and equitably than will the proposed non-deductibility provision, taken with lower corporate tax rates. Under these circumstances, NATSO believes that tax reform may better be left until the current law, recent changes to which were enacted in 1982 and 1984, has been allowed to operate fully for several years. It seems somewhat pointless to attempt a major restructuring of the tax code even before the small business community has had time to adjust to current law.

INDEXING FUEL TAXES IS ALSO UNFAIR

NATSO also opposes indexing excise taxes, especially those on motor fuels, forcing an automatic inflationary factor into this area of tax. This is particularly a problem, and is more unfair, when fuel prices are as low as they have been in years and can only be expected to rise again. Equally significant, NATSO rejects the notion that excise taxes ought to be raised without an affirmative vote of Congress.

I previously referred to the Highway Trust Fund and its relationship to fuel excise taxes. Indexing these taxes will create new issues with respect to the HTF, since the proposal seems to contemplate using those added funds to offset other general revenue deficits resulting from tax reform. NATSO strongly objects to that approach. No fuel excise taxes should be diverted from the HTF, which has a current surplus that will be needed in the future to sustain the nation's infrastructure. Increasing excise taxes through indexing should not change the basic premise that highway users should pay for highway construction and maintenance. Indexing fuel taxes to pay for tax reform is not an acceptable use of those funds.

CONCLUSION

NATSO appreciates the opportunity to describe the complex taxing policies and mechanisms that comprise current motor fuels excise taxes. We believe our comments conclusively demonstrate that these excise taxes are not income for truck stop operators and that the proposal to tax these monies would place an untenable and unwarranted burden on these businesses as mere collectors of these taxes.

Not even lower effective corporate tax rates will compensate truck stop operators on balance for the onerous financial effects they will suffer under the proposal. Additionally, NATSO opposes non-deductibility because serious competitive imbalances, at least in the short run, will result as businesses either pass along the cost of tax reform to customers or absorb part of such increases. The long range result, though, is that non-deductibility will place a regressive tax increase on many consumers of motor fuels who cannot afford it. Indexing will unfairly increase excise taxes without direct Congressional approval and improperly shift funds out of the Highway Trust Fund.

For all the reasons discussed in this statement, the Finance Committee should reject the ideas of the non-deductibility and indexing of excise taxes as part of the tax reform package.

STATEMENT OF THE
NATIONAL AUTOMOBILE DEALERS ASSOCIATION
ON
THE DEDUCTIBILITY OF EXCISE TAXES AND TARIFFS
BEFORE
THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

Jimmy Payton
Chairman, Government Relations Committee

Bernie Uhl
Chairman, American Truck Dealers Division

Frank E. McCarthy
Executive Vice President
National Automobile Dealers Association
8400 Westpark Drive
McLean, VA 22102

Mr. Chairman, my name is Jimmy Payton. I am the chairman of the Government Relations Committee of the National Automobile Dealers Association. I am here representing 20,000 auto and truck dealers who retail their products through 39,000 import and domestic franchises. While we represent franchised dealers of all makes, the excise tax and tariff non deductibility will severely impact 18,000 of our members who retail imported vehicles and the over 1,800 who sell medium and heavy-duty trucks.

I am the owner of Payton-Wright Ford-Subaru, Inc., of Grapevine, Texas.

Mr. Chairman, while the National Automobile Dealers Association supports your effort to reduce the federal deficit and simplify our tax system, we are strongly opposed to eliminating the deductibility of federal excise taxes and import tariffs because it is bad tax policy and will result in sharply higher prices to consumers for light, medium and heavy-duty trucks as well as imported cars. Tax reform that helps consumers can be supported by NADA, but proposals to eliminate excise tax and import tariffs deductibility do not meet that test. For the franchised truck dealers of the country, your plan could also be the rope that ultimately hangs them.

The last statement may sound extreme, but let me explain. Since 1982, truck dealers have paid a 12 percent retail excise tax to the federal government at the time of sale for every truck with a gross vehicle weight rating over 33,000 lbs., on trailers and semi-trailers over 26,000 lbs., and all on highway tractors. In fact, franchised dealers are responsible for the tax. Present law permits them to deduct the FET from their income for tax purposes and in effect, the dealer acts as a collection agency for the government.

In fiscal 1985, the 12 percent retail excise tax raised in excess of $1 billion and was the 9th largest of approximately 50 federal excise taxes.

If this committee goes ahead with the chairman's plan to eliminate this deductibility, truck dealers not only could not deduct the tax but, in fact, would be taxed on the tax.

Let me give you some idea of what kind of impact this can have. A typical heavy-duty truck retailed in the U.S. for $75,000 in 1985. The excise tax on each of these average trucks ran to $9,000 in 1985. Truck dealers sold 132,307 heavy-duty trucks in 1985. Under the chairman's plan, truck dealers would have added $1.19 billion to their taxable income in 1985, none of which was their's to keep to begin with. Using available industry data we estimate that individually, the chairman's proposal would have increased the burden of the average truck dealership by $153,743, a whopping 96% increase, compared to present law. In the annals of patently unfair tax policy, this plan may well be one for the record books.

Bad as this is, however, it is compounded by the chairman's plan to also eliminate the deductibility of tariffs placed on imported light, medium and heavy-duty trucks. In the case of imported medium-duty trucks, this figure is 4 percent but for imported light trucks this figure is a substantial 25 percent. All told the tariffs on imported vehicles and parts paid in 1985 exceeded $2 billion.

Franchised auto dealers sold 2.8 million imported automobiles and nearly 800,000 imported trucks in the U.S. in 1985. The tariff on these vehicles is 2.6 percent and 25 percent respectively. Losing the deductibility of these tariffs would force their import vehicle distributor to immediately raise the price of the typical import car by an estimated $120 and the typical import truck by an estimated $880.

It may be the desire of the U.S. government to retaliate against foreign governments because of certain trade policies but I do not believe it necessary to punish a specific segment of our economy to implement that policy.

We also appreciate that in theory the loss of excise tax deductibility and import tariff deductibility would ultimately be passed on to the consumer but in the case of the retail truck industry this likely will not be the case. Currently about 75 percent of all medium and heavy-duty trucks are sold by their manufacturers directly to major fleet operators and lease companies. The remainder are sold by truck dealers to smaller operators and individuals. Manufacturers have the economic power to absorb at least some of the added cost of losing the deductibility of the federal excise tax and import tariffs, but truck dealers in the current market simply don't.

The typical truck dealer today makes less than 2 percent margin on the sale of a medium or heavy-duty truck and indeed statistics indicate that after adding selling expenses that a good number make no money, or lose money on truck sales. Furthermore, projections by NADA and many others in the truck industry indicate that the retail truck market will be even more competitive in future years.

In short, dealers simply cannot raise the prices of their products anywhere near necessary to recover the added cost of being taxed on the federal excise taxes they must collect for the federal government.

Again, let me use an example derived from industry figures.

If a typical dealer had $4 million in receipts from taxable vehicle sales, we calculate, based on data gathered by our sister organization, the American Truck Dealers, that this dealer's federal tax liability would be $160,133 under present law.

Under the House of Representatives tax reform measure, the federal tax liability would be $150,044.

Under the Chairman's proposal, however, the federal tax liability would be $313,876 or $153,743 more than present law, and $163,832 more than the House passed tax reform bill.

If this committee goes ahead with this plan, you are assigning this country's truck dealers to the economic scrap heap. We have attached an analysis based on real world data to explain this point further and would urge you to read it carefully.

In closing, NADA and ATD would like to say that while it supports the general thrust of the committee's efforts, it urges the members to reject this part of its plan as: unfair taxation of our members who provide the imported vehicles, cars and trucks consumers want; an unwarranted increase in price for equipment that moves more than 90 percent of all goods in the U.S.; and bad tax policy.

I would be pleased to answer any questions you might have.

N

THE NATIONAL BLACK CAUCUS OF STATE LEGISLATORS

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NBCSL PRESIDENT DISPUTES VALUE OF EXCISE TAXES AS REVENUE SOURCE

Washington, D.C., April 21, 1986 -- "The excise taxes proposed by the Senate Finance Committee staff are grossly unfair," said Maryland state Sen. Clarence M. Mitchell, III in testimony today before that committee. "Such a proposal spells danger to the pocketbooks of every low-income worker."

Sen. Mitchell, speaking on behalf of the National Black Caucus of State Legislators of which he is president, described this proposal as "reverse Robin-Hoodism," taking from the poor and giving to the rich. He has taken this position in previous Congressional hearings against excise taxes, contending that they impose a heavier financial burden on low-income people and are grossly unfair.

NBCSL is an organization of 396 black state legislators spanning 42 states. Its collective constituency numbers over 26 million people.

-30-

"A National Network For Political Equality!"

Let's complete what President John F. Kennedy began when he repealed excise taxes on luxuries like jewelry and fur coats in 1961. Let's sweep them all away now.

As State Legislators we, like members of this Committee, are faced with the need for tax reform and fiscal responsibility. We are also acutely aware of the need for fairness in tax reform. And so are our constituents. Above all else, the voters -- who elect us or reject us at the polls -- want fairness in taxation. They get very upset when they have to pay more taxes on a single pack of cigarettes or telephone call or a six pack of beer than some giant corporations or millionaires have to pay in their entire yearly income tax.

My constituents call that kind of tax system a scandal. And I agree. I am sure you do too, Mr. Chairman. As legislators who heed what the voters are saying, we should be more concerned that tax reform is fair than that it is either simplified or revenue neutral.

Frankly, Mr. Chairman we are concerned about the present proposal because it relies so heavily on excise taxes. And excise taxes fail to pass any standard of fairness. The burden of excise taxes falls disproportionately on the poor and on low-income wage earners. The smaller your income, the greater the tax burden caused by excise taxes.

A study was just published today by the Citizens for Tax Justice. It was prepared by the Social Welfare Research Institute at Boston College. It reveals a dramatic imbalance. The excise tax increases contained in the staff proposals before your committee would wipe out 80 per cent of the tax savings that a family earning less than $11,000 a year would receive under the House-passed tax reform bill.

Even the typical middle-income family with yearly earnings of under $47,000 would lose nearly half (48 per cent) of their tax cuts in the House version, as a result of the excise tax increases in this committee staff proposal.

If there was ever a case of one hand, or Upper House, taking away what the other hand, or Lower House, giveth, the proposal before you is a classic example of it.

It's even worse, Mr. Chairman. The proposed increases in excise taxes add insult to the injury caused by these already excessive and regressive taxes.

In the name of achieving a streamlined and simplified tax code, the staff proposal asks low-and middle-income Americans to bear a hevier tax burden.

In the name of tax neutrality, the staff proposal asks the impoverished to absorb tax boosts so the affluent can get tax breaks.

The staff proposal uses broad-based excise tax increases to provide tax preference for timber, oil, gas and natural resource interests. The right name for this kind of redistribution of wealth is not tax reform. It's "Reverse Robin Hood-ism". It's taking from the poor and giving to the rich.

I urge you to reject the staff proposal as a bad idea whose disposal time has now come.

Thank you.

N

National School Transportation Association
Post Office Box 2639 • Springfield, Virginia 22152 • Area Code 703-644-0700

April 21, 1986

LARRY DURHAM, CA
President

BOB HARMON, MO
1st Vice President

SETH CORWIN, NY
2nd Vice President

ROGER WELCH, MA
Secretary

DON HOFFMAN, MN
Treasurer

KAREN FINKEL
Executive Director

Ms. Betty Scott-Boom
Room 219, Dirksen
Senate Office Building
Washington, DC 20510

Dear Ms. Scott-Boom:

Per our earlier conversation, enclosed is the statement of the National School Transportation Association for inclusion in the April 21, 1986 hearing record.

Sincerely,

Karen Finkel

Karen Finkel
Executive Director

KF/sb

NSTA National School Transportation Association
Post Office Box 2639 • Springfield, Virginia 22152 • Area Code 703-644-0700

April 21, 1986

LARRY DURHAM, CA
President

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DON HOFFMAN, MN
Treasurer

KAREN FINKEL
Executive Director

The Honorable Bob Packwood
Chairman, Senate Committee on Finance
Room 219 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

I write to you on two matters of great urgency in my capacity as president of the National School Transportation Association (NSTA). NSTA was founded in 1964 by school bus contractors to "promote and foster the highest degree of safety in the transportation of school children." Today, contractors represent approximately 37 percent of the nation's yellow school bus fleet with members in all 50 states. Our membership reflects both large companies with fleets of thousands of buses to the smaller firms operated by the same family through several generations.

It has come to my attention that a draft tax reform proposal now being utilized as the Committee's tax reform mark-up document includes two provisions of particular concern to the school transportation industry. The draft proposes that the existing deduction for excise taxes be eliminated, and that future tax rate determinations reflect the impact of inflation. We are fearful that such a proposal could result in the elimination of the full exemption from excise taxes on motor fuel, parts, accessories, and tires, as well as the twelve cents-a-gallon exemption from diesel fuel excise taxes which school bus contractors are entitled to under current law. Technical corrections provided in H.R. 3838 would extend the exemption from diesel fuel taxes for contracted school buses to the full fifteen cents-a-gallon. In view of our special mission of transporting the nation's school children, to repeal these exemptions would be both unfair and ultimately shift a greater burden to local taxpayers.

Our early estimate is that elimination of our exemption from the motor and diesel fuel taxes alone would cost our typical member more than $300 per bus annually — a cost that would assuredly have to be absorbed by the localities to which we provide service. When coupled with the detrimental impact of elimination of the Investment Tax Credit and less favorable depreciation treatment, our total loss under the tax plan as presently constituted would be quite significant.

There is little doubt that this proposal would result in a strong disincentive for our member companies to invest in new school buses. We would certainly urge that you reconsider the impact of elimination of the ITC to an industry such as ours.

I urge your consideration of these concerns as you attempt to move the Committee through the drafting process. I stand ready to provide you with further background as necessary. Your consideration of these matters of great urgency to our industry is deeply appreciated, and I look forward to working with you toward favorable resolution in the days ahead.

Sincerely,

Larry K. Durham

Larry K. Durham
President

NTDRA

NATIONAL TIRE DEALERS & RETREADERS ASSOCIATION, INC.
Suite 400, 1250 Eye Street, N.W., Washington, D.C. 20005 (202) 789-2300 (800) 368-5757

COMMENTS OF PHILIP P FRIEDLANDER, JR.

EXECUTIVE VICE PRESIDENT

NATIONAL TIRE DEALERS AND RETREADERS ASSOCIATION

CONCERNING

DEDUCTIBILITY OF EXCISE TAXES AND TARIFFS

submitted to the

COMMITTEE ON FINANCE

UNITED STATES SENATE

April 21, 1986

President LOUIS KARRAS *President Elect* E. R. BROWN *1st Vice President* DON PERRY *2nd Vice President* JOE DePAOLIS *Treasurer* JOHN SHIMER *Corporate Secretary* JERRY BAUER *Executive Vice President* PHILIP P. FRIEDLANDER, JR.

April 21, 1986

Mr. Chairman:

My name is Philip P. Friedlander, Jr. I am Executive Vice President of the National Tire Dealers and Retreaders Association, a national nonprofit trade association representing approximately 5,000 independent tire dealers and retreaders located in all 50 states. NTDRA's members are engaged in the wholesale and retail distribution of automobile and truck tires, the retreading of tires, and the sale of related products and services.

NTDRA is appreciative, Mr. Chairman, of this opportunity to have input into this committee's deliberations on the proposal to end the deductibility of excise taxes and tariffs for income tax purposes. We commend you for convening this hearing despite being well into the markup process. We believe, however, that this hearing is necessary to a full understanding of the impact of this proposal. NTDRA believes that after the ramifications of this proposal are exhaustively reviewed that this committee will recognize that this proposal is regressive, unnecessarily complex, and wholly out of place in an income tax reform package, the purpose of which is to simplify and increase the fairness of the federal income tax code.

Mr. Chairman, NTDRA's parochial interest is obviously the impact this proposal to deny the deductibility of the excise tax on tires and the tariff on tires and casings will have on this association's members. Many of our members are importers of record of foreign made new and retreaded tires. As importers of record they are liable for the manufacturer's federal excise tax on those tires weighing over forty pounds. The tax of course is graduated on the basis of weight. Also, as importers of record they must pay a duty, generally 4%, on imported new and retreaded tires and tire casings. In addition our retreader members who retread truck tires weighing over forty pounds are liable for the federal excise tax if the retreaded tire were produced on a previously untaxed casing.

If the amount of federal excise taxes and tariffs paid by these individuals is no longer recognized as an "ordinary and necessary" business expense or expense incurred in the production of income, they will experience a real increase in their income tax burden. That increased burden can of course be reduced to the degree our members can pass along these increased costs to their consumers.

If this proposal is adopted, a seller in the 35% income tax bracket would have to increase the present cost of his product by 54% of the excise tax and tariffs paid in order to maintain his or her prior after tax income. In an industry which has become increasingly cost competitive it is unrealistic to assume that the full cost of the seller's increased tax liability could be passed along to the consumer. This proposal, therefore, would impact directly and adversely the profitability of thousands of small business men and women engaged in the wholesale and retail distribution of new and retreaded tires.

Those dealers and retreaders who are payors of the FET and tariffs are not the only ones in the retail and wholesale tire industry who will be adversely impacted if this proposal is adopted. Tire manufacturers will see their tax liability increase. And they will surely pass along at least a part of their added costs to their customers, our members, as they attempt to maintain their prior after tax profitability. This will mean a very real increase in the cost of maintaining inventory for every wholesaler or retreader of tires over 40 pounds. That includes virtually every independent tire dealer. This proposal therefore will adversely impact the profitability of more than just the tire dealer and retreader who is the direct payor of the FET. Because the dealer most likley will not be able to pass along the full increased cost of carrying his or her inventory, this proposal will harm nearly all retail and wholesale tire establishments in the nation, of which there are approximately 16,000.

Mr. Chairman, since this proposal first came to light the media has focused primarily on whether the excise tax on specific products was high enough. Certain interests have called for increasing the tax on certain alcoholic beverage products noting that the federal excise tax on these products has remained constant since 1951. Others have maintained that the excise tax on alcoholic beverages and tobacco products are not high enough to cover external social costs associated with the product. NTDRA would submit that there are no such external social costs associated with the consumption of tires.

Others have argued that this proposal, which in effect increases all excise taxes, is justified with regard to the excise tax on tires, motor fuels, heavy trucks and trailers. They point out that the excise tax on these products is a surrogate user's fee, with revenues going to fund federally provided services.

It is correct that the above named excise taxes constitute a direct or surrogate user's fee. Revenues from these excise taxes go to the Highway Trust Fund to finance federal-aid highway programs. These excise taxes were extensively reviewed and revised when Congress adopted the Surface Transportation Assistance Act of 1982, which was signed into law in January of 1983. Some I believe have been reviewed subsequently by committees of the Congress.

Congress therefore has taken a recent hard look at what the appropriate level should be for these "user fees" and has rendered a judgement. Nothing has transpired, of which this association is aware, that would render these very recent judgements of Congress invalid. Moreover, Mr. Chairman, the excise tax rates were set in 1982 at a level necessary to fund a projected level of federal highway spending. That projected level of spending is not currently being maintained and is unlikely to be maintained in light of the deficit reduction constraints of the Gramm-Rudman-Hollings legislation. As a result, the Highway Trust Funds continue to accumulate at a rate far exceeding anticipated spending levels. Clearly, the current level of transportation-related excise taxes is adequate to fund the federal-aid highway programs.

I think the committee recognizes that the nation's tire manufacturers, tire wholesalers, tire retailers, importers, private branders and retreaders will pass along at least a portion of the increased tax liability imposed by this proposal to the consumers of their products. These consumers will in turn pass along their increased costs to the consumers of their goods and services. By increasing the tax liability of tire dealers and retreaders, tire manufacturers, truck retailers, trucking companies, etc., you are making a conscious decision to increase transportation costs in this country. That increase in transportation costs will increase the costs to the general public of virtually every product in the marketplace today. By increasing transportation costs, as you are surely doing by denying the deductibility of the excise tax on tires, motor fuel, trucks, etc., you will increase the ultimate costs of basic necessities such as food, clothing, housing materials, home heating products, health care, etc. And on whom will these increased product costs fall most heavily? The answer is unmistakably clear. They will fall on those Americans with lower incomes and limited resources. Few changes in the tax code could be more regressive than, in effect, to increase transportation-related excise taxes.

Our tax code has historically been based, at least in theory, on the concept that individuals and businesses were taxed in relationship to their ability to pay. When the President called for income tax reform it was clear he was calling for reforms in the inequity of the income tax system. Neither in the so-called Treasury I, Treasury II, or the House-passed tax reform bill were there any proposals to alter the excise tax system as an integral part of income tax reform.

Mr. Chairman, NTDRA recognizes the difficulty facing your committee. We recognize that in order to preserve existing tax preferences for a variety of interests there is a need to increase revenues in order for the ultimate legislative product of this committee to be revenue neutral. However, this association, which has openly supported rate-based income tax reform, tax code simplification, and the reform of a tax system where billion dollar corporations with hundreds of millions in income pay no taxes, cannot support this proposal. We must oppose it because it is regressive. It is complex. And in so far as it applies to tires, trucks, motor fuels, etc., it will further burden the ground transportation sector of our economy which already is paying its fair and necessary tax share to maintain the federally financed highways of this nation.

Mr. Chairman, this association would like to point out that this proposal flies in the face of tax and accounting principles that have been recognized almost since the inception of the income tax. Gross income has never been taxed. The tax code has traditionally recognized that expenses incurred in the production of income and "ordinary and necessary" business expenses were deductible. Taxes paid by businesses have traditionally been recognized as business expenses and have been deductible for income tax purposes. Rather than assault these principles it would be better for the committee to directly increase excise taxes. Why go through the complex charade of denying businesses the deductibility of excise taxes and tariffs?

But we cannot imagine that this committee would resort to such a regressive method of raising revenue. We cannot conceive that this committee would increase the transportation-related excise taxes (particularly the tax on tires), which are clearly paying their way. Surely, no member of the committee believes the public will accept a so-called tax reform bill that pays for the preservation of special interest tax preferences with money raised by indirectly increasing the costs of virtually all consumer products.

Mr. Chairman, we would respectfully submit that were this proposal to be adopted it would further undermine public confidence in the essential fairness of the tax code. It would potentially have an adverse impact on the economy. It would certainly have an adverse impact on the nation's tire dealers and retreaders. We would urge the committee to reject this ill-conceived proposal.

In conclusion, we would like to thank you again for the opportunity to have input into the committee's deliberations. We recognize the difficult task which confronts you. We hope that the result of your deliberations will be an income tax reform bill which enhances the code's fairness, reduces the code's unnecessary complexity and provides incentive for economic growth through reduced rates.

A

STATEMENT OF MR. BERNIE UHL, CHAIRMAN
OF THE
AMERICAN TRUCK DEALERS DIVISION OF THE
NATIONAL AUTOMOBILE DEALERS ASSOCIATION

8400 WESTPARK DRIVE, MCLEAN, VIRGINIA

Before The
Senate Finance Committee's Hearing on
Excise Taxes

Senate Dirksen Building SD 215

April 21, 1986

My name is Bernard Uhl. I am the Chairman of the American Truck Dealers Division of the National Automobile Dealers Association, located at 8400 Westpark Drive, McLean, Virginia.

I am also the owner of International Truck dealerships in Palmyra, IN; Louisville and Elizabethtown, KY. Thus, I can speak on behalf of the over 1,800 truck dealer members of ATD, as our organization is known in the industry, and as a businessman with real-world experience in the operations of a truck dealership.

Without hesitation, ATD expresses its strong opposition to Chairman Packwood's proposal to deny a deduction for federal excise taxes.

As background, Section 512 of the Highway Revenue Act of 1982 converted a 10% manufacturers' excise tax on certain truck chassis and bodies, trailers and semitrailers over 10,000 pounds GVW, and highway tractors, to a 12% retail excise tax on certain truck chassis over 33,000 pounds GVW, on trailers and semitrailers over 26,000 pounds GVW, and on highway tractors. Excise taxes on all parts and medium class trucks were removed at the same time because, in part, excise taxes are bad methods of tax collection. They are hidden and often create inequities in the retail sales of items even as they increase transaction and accounting costs.

For simplicity's sake, I'll refer to these various transportation vehicles as "taxable vehicles", and the tax as the "12% retail truck tax".

In Fiscal Year 1985, the 12% retail truck tax raised nearly $1.3 billion. This is a significant levy and makes the 12% retail truck tax the 9th largest federal excise tax out of the approximately 50 federal excise taxes.

As ATD reads the Chairman's excise tax proposal, a truck dealer would include the 12% retail truck tax in his dealership income for federal tax purposes. Translated into real world tax numbers, the proposal would increase the annual tax burden of a typical truck dealership by $153,743, a whopping 96% increase, compared to present law!

Allow me to explain why this is so.

Since the publication of Treasury I in 1984, the ATD has calculated the tax burden under present law compared to Treasury I, II, and the House-passed tax reform legislation, H.R. 3838, for a typical truck dealership.

ATD is able to make these calculations because ATD collects extensive monthly financial data from a cross section of ATD members.

Although we recognize that any tax calculation is hypothetical, and not specific to any one truck dealership, we believe our calculations provide guidelines for judging the various tax reform proposals from the viewpoint of truck dealers.

Now, let's factor in the typical truck dealer paying a tax on the 12% retail truck tax, as would happen under the Chairman's proposal.

If the hypothetical dealer had $4,000,000 in receipts from taxable vehicle sales, ATD calculates this dealer's federal tax liability would be $160,133 under present law.

Under the House bill, the federal tax liability would be $150,055.

Under the Chairman's proposal, the federal tax liability would be $313,876 or $153,743 more than present law, and $163,832 more than the House-passed reform bill. These numbers represent a 96% tax increase!

Attached to this statement is a detailed explanation of how ATD arrived at these numbers (Attachment A). Briefly, the hypothetical dealer has $10,000,000 in total receipts from new truck sales, used truck sales, parts sales, and his service department, not accounting for the 12% retail truck excise tax on new truck sales. His tax liability was calculated on the premise that costs of goods sold equal 85% of receipts, and that tax deductions equal approximately 10 to 12% of gross receipts minus cost of goods sold. Our analysis of the various tax reform proposals do not reveal substantial differences in tax deductions when they are compared to present law.

In all fairness to the Chairman's proposal, we calculated a $50,000 "expensing" deduction, even though our data does not support the premise that most truck dealers could utilize this provision in the Chairman's proposal.

If the hypothetical truck dealer "expensed" $50,000 and was eligible to depreciation of $150,000 at a 200% declinig balance (the most generous circumstances under the Chairman's proposal), his tax liability would be $312,826, or only $1,050 less than when the $50,000 expensing provision is not utilized.

But, in an attempt to be even more fair to the Chairman's proposal, we calculated the tax burden on a hypothetical dealer one half the size of our dealer with sales of $2 million in taxable vehicles.

Under present law this dealer has a tax liability of $69,198, and under the House-passed bill of $65,682.

Under the Chairman's proposal, even with $50,000 expensing, his tax liability would be $155,649, or nearly $90,000 more than present law.

Ironically, the inclusion of the 12% truck tax in income prevented this smaller dealer, with taxable income of approximately $200,000, to be denied the Chairman's proposed graduated corporate rate for taxable income that is less than $350,000. In other words, a similarly situated business, not including a 12% excise tax in its income, would pay approximately $57,000 in federal taxes compared to our truck dealer's $155,000! This is just not fair!

We at ATD recognize that the Chairman and others have said that business will pass the new excise tax burden on to its customers. ATD does not believe that truck dealers can successfully pass this tax on to our customers.

For example, let's assume a truck dealer sells an $80,000 over-the-road tractor. The 12% truck excise tax is $9,600. At a 35% tax rate, the increased tax liability is $3,360. If the dealer charges the customer $83,360, then the 12% truck excise becomes $10,003, or a $403 increase that is subject to the 35% rate, or $141 more in taxes. Thus, the cycle never really ends with a retail tax.

The ATD commends the deSeve Economics study of this issue. Even though the deSeve report to The Council Against Regressive Taxation (CART) increase in the $80,000 price of the over-the-road tractor would give the truck dealer the same after tax income as present law, common sense tells ATD's 1,800 dealers that we are not and cannot increase prices over 50%. Instead, we are going to pay considerable more taxes despite rate reductions.

Just as the dog never truly catches its tail, the American truck dealer, a true independent business, will never totally pass along the 12% retail truck tax to the truck purchaser.

There are two more cruel twists in the Chairman's proposal.

First, it rewards the inefficient, non-profitable truck dealer compared to the successful truck dealer. It does so in this manner: The non-profitable dealer will pay a federal income tax of perhaps 15 to 25% on the excise tax he collects, whereas the profitable dealer will pay a 35% tax.

In the truck sales business, we will frequently submit a bid to a potential customer because trucks are brought by business people, not consumers casually shopping for a $80,000 over-the-road tractor. The dealer in the 35% tax bracket will have a tax cost of $3,360 in his bid on a $80,000 rig, whereas the non-profitable dealer can therefore automatically underbid the profitable dealer by almost $2,000 or 2.5% of the purchase price.

On the other hand, the Chairman's proposal is also cruel to the non-profitable dealer. As widely interpreted, the Chairman's proposal includes a so-called "anti-avoidance" rule which requires a dealer with no taxable income to pay a federal income tax on his excise tax collections. If the dealer has excise tax collections of $400,000, his tax bill may be $140,000. Such a tax burden on a dealer not making profits would obviously be the death knell - he would just go out of business.

In sum, Mr. Chairman, the proposal to make the 12% truck tax an item of a truck dealership income will have a direct, severe, and negative impact on all truck dealers selling taxable vehicles. The impact will be in real dollars.

And, not to be underestimated, another serious impact will be lower truck sales, as documented by representatives of the trucking industry. Truck dealers have just now recovered from the depressed sales of the early 1980's. To send sales crashing again in the name of tax reform would be a disaster for America's truck dealers, and our employees.

Finally, Mr. Chairman, I would be derelict if I did not take this opportunity to denounce the 12% retail truck tax. It should be repealed. It has nothing to do with highway use. ATD continues to fight for its repeal. Our belief that the 12% retail truck tax is a bad tax policy, in the first instance, explains, why we are so strong in our opposition to the Chairman's proposal, which makes a bad tax much worse.

We state our opposition with respect to the Chairman, but we do so strongly.

Thank you for this opportunity to present the ATD's views to the Committee. I will be pleased to answer any questions.

N

NAVISTAR INTERNATIONAL CORPORATION

TESTIMONY BEFORE THE U.S. SENATE FINANCE COMMITTEE

APRIL 21, 1986

DEDUCTIBILITY OF FEDERAL EXCISE TAXES AND TARIFFS

POINTS

1. Requiring the inclusion of federal excise taxes in income without a corresponding deduction is arbitrary and unfair because this would impute taxable income to a corporation when, in fact, no income has been earned.

2. Disallowing the deductibility of excise taxes is contrary to basic income tax policy, which allows all ordinary and necessary expenses associated with the conduct of a trade or business to be deducted from gross revenues in determining taxable income.

3. Disallowance of the deductibility of excise taxes would result in discrimination against those industries currently impacted by excise taxes, resulting in a higher tax rate being imposed on those industries.

4. The trucking industry is already one of the most heavily taxed industries in the country. Competing modes of transportation, such as railroads, have much lower effective income tax rates and, since they pay little or no excise tax, would be relatively untouched by this proposal.

5. The "anti-avoidance rule" would impute taxable income to a corporation merely because it is responsible for the collection and payment of excise taxes. The income tax would be payable regardless of a corporation's true economic income or net operating loss carryovers.

6. The "anti-avoidance rule" acts as a new minimum tax on corporations required to collect and remit excise taxes to the government, even though those corporations may be currently unprofitable or have incurred tax losses in prior years.

7. Navistar has incurred substantial tax losses in prior years, but under the anti-avoidance rule would be deemed to have annual taxable income equal to the amount of excise tax collected, which could not be offset by our tax loss carryovers.

8. Navistar urges the elimination of the "Deductibility of Federal Excise Taxes and Tariffs" provision from the Finance Committee tax reform proposals.

WRITTEN STATEMENT
OF
JAMES C. COTTING
VICE CHAIRMAN AND CHIEF FINANCIAL OFFICER
NAVISTAR INTERNATIONAL CORPORATION

CONCERNING
PROPOSED ELIMINATION OF DEDUCTIBILITY OF FEDERAL EXCISE TAXES AND TARIFFS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

APRIL 21, 1986

Navistar International Corporation wishes to express its strong objections to the "Deductibility of Federal Excise Taxes and Tariffs" provision introduced last month in the Finance Committee tax reform proposal on the basis that this provision (1) is arbitrary and unfair, (2) is contrary to basic tax policy, (3) is discriminatory against a select number of industries, and (4) ignores true economic income and operates as a minimum tax.

Arbitrary and Unfair - The provision requiring the inclusion of federal excise taxes in income without a corresponding deduction is arbitrary and unfair, since this provision would impute taxable income to a corporation when, in fact, no income has been earned. The federal excise tax operates as a federal sales tax whereby some corporations merely collect tax from customers and remit that tax to the federal government. In this situation, there is no rationale for attributing taxable income to those corporations. In addition, the federal excise tax is an uncontrolled cost imposed by the federal government, and does not add any value to the final product.

Contrary to Basic Tax Policy - The provision which disallows the deductibility of excise taxes is contrary to basic income tax policy. Current income tax policy allows all ordinary and necessary expenses which are associated with the conduct of a trade or business to be deducted from gross revenues in determining taxable income. To disallow the deductibility of excise taxes would result in a distortion of net income, similar to the distortion that would result in the case of the disallowance of production or marketing costs.

Discriminatory Against a Select Number of Industries - Excise taxes are imposed on a select group of businesses and the disallowance of the deductibility of these taxes would result in discrimination against those industries currently impacted by the excise taxes. This discrimination will result in a higher tax rate being imposed on certain industries. The trucking industry is already one of the most heavily taxed industries in the country. Competing modes of transportation, such as railroads, pay little or no excise tax and so would be relatively untouched by this proposal. These same competing modes already have much lower effective tax rates than the trucking industry. This competitive disadvantage would be substantially increased by the Chairman's proposal.

In addition, truck excise taxes are, by and large, imposed for specific purposes--mainly, they are user fees designed to fund highway construction and repair. Increasing the cost of these taxes without earmarking the money for the original purpose is simply an unfair and discriminatory income tax increase which burdens a small number of selected industries.

Ignores Economic Income and Operates as a Minimum Tax - The anti-avoidance rule would impute taxable income to a corporation merely because it is responsible for the collection and payment of excise taxes. This income would be subject to the maximum corporate tax rate and the tax would be payable regardless of a corporation's true economic income or net operating loss carryovers. This anti-avoidance rule is a drastic change from current law, and would operate as a new minimum tax on corporations required to collect and remit excise taxes to the government even though those corporations may be currently unprofitable or have incurred tax losses in prior years.

In the case of Navistar, we have incurred substantial tax losses in prior years. Under the anti-avoidance rule, Navistar would be deemed to have annual taxable income equal to the amount of excise tax collected, which could not be offset by our tax loss carryovers.

Conclusion - For the reasons cited above, we urge you to eliminate the "Deductibility of Federal Excise Taxes and Tariffs" provision from the Finance Committee tax reform proposals.

N

NYS-BWA
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April 23, 1986

Committee on Finance
United States Senate
Room SD 219
Dirksen Senate Office Building
Washington, DC 20510

Testimony in Opposition To Removing The Deductibility of Excise Taxes.

Gentlemen, my name is Alfonso Lubrano. I am the President of the New York State Beer Wholesalers Association, representing the franchised beer wholesalers in New York.

I submit the following in support of our opposition to Removing the Deductibility of Excise Taxes on beer.

Federal excise taxes paid by brewers and other firms are a legitimate business expense, like labor costs. Both are necessary costs of doing business and, as such, should be deductible.

Any plan designed to provide tax cuts to lower-income groups would be less effective if excise tax deductions were abolished. As Sen. George J. Mitchell (D-Maine) says: "Generally, I do not favor raising excise taxes to reduce income taxes. That's raising a regressive tax to reduce progressive taxes."

In the case of beer, the burden would fall disproportionately on lower-income consumers. It's estimated that 80% of U.S. beer shipments are consumed by families earning less than $30,000 a year.

Nondeductibility of excise taxes on products like tires and fuel would mean higher cost for the transportation industry. These increased distribution expenses would be passed on to wholesalers of all products, and ultimately, to consumers.

**New York State
Beer Wholesalers
Association, Inc.**

Page Two April 23, 1986

Eliminating the deductibility of federal excise taxes can in no way be considered tax reform. It is just the opposite, since it represents a step toward taxing businesses' gross income.

Additionally, New York is particularly vulnerable to any changes in the cost of beer to the consumer. During the past 30 months, 25 beer wholesalers, thriving small businesses, many of whom were third generation operations, have gone out of business. These small businesses represent the backbone of those with the highest employment levels in New York.

This Association only eight short years ago had a membership of 175. Today, we have only 103 members left.

In short, Gentlemen, the beer wholesaling industry in New York cannot survive any further shocks to its economic stability. We urge you to defeat any tax proposal that will increase the cost of beer.

Thank you.

Respectfully Submitted,

Alfonso Lubrano,
President

AL/md

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O

To: Senate Finance Committee

STATEMENT ON EXCISE TAX PROPOSALS

My name is William W. Oliver. I have been a tax professor at the Indiana University School of Law for 32 years. Our family also owns a small winery near Bloomington, Indiana

To Deny Deductions for Excise Taxes Paid

This is a shocking proposal. Our income tax is a net income tax, i.e., expenses of earning income are deductible.

This would be the opposite of a tax preference. It would be a tax shaft. It will be bitterly resented by its victims and reduce respect for our tax system and for the Congress even further.

To Raise the Excise Tax on Wine

This comes at a horrible time. Imports of wine have risen in the last few years from less than 10% to 30%. The wine industry is in distress along with steel, textiles, rubber, etc.

Estimates of decreases in the sales of wine from this proposal range from a low of 8% to as high as 20%. Many acres of American vineyards will either be abandoned or bulldozed out. Since it takes years to develop a vineyard, this will mean reduced capacity for American wineries, thus locking in wine imports at a high level. This means wine will continue for many years to add to our adverse trade balance.

Angrily Submitted,

William W. Oliver
May 2, 1986

P

PMAA PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Statement of the

PETROLEUM MARKETERS ASSOCIATION OF AMERICA

for the

SENATE FINANCE COMMITTEE HEARING

on the

TAX REFORM PROPOSAL AFFECTING THE

DEDUCTIBILITY OF FEDERAL EXCISE TAXES AND TARIFFS,

TAXATION OF WINE AT RATES EQUIVALENT TO BEER, AND ADJUSTMENT OF

ALCOHOL, TOBACCO AND FUEL EXCISE TAXES TO REFLECT INCREASES IN PRICE

Monday, April 21, 1986
Washington, D.C.

Petroleum Marketers Association of America
1120 Vermont Avenue, N.W., Suite 1130
Washington, D.C. 20005

(202) 331-1198

The Petroleum Marketers Association of America (PMAA), formerly the National Oil Jobbers Council, is a federation of 41 state and regional associations representing some 11,000 petroleum product marketers throughout the United States. Collectively these marketers sell approximately half the gasoline, 60 percent of the diesel fuel and three quarters of the home heating oil consumed in America today. While virtually all of these marketers are small businessmen, their collective assets would rank them 17th on Fortune 500's list of companies ranked by assets.

PMAA commends you, Mr. Chairman, for your willingness to hold hearings on this critical issue. While we understand the need, and support the objective of tax reform, we cannot support any such "reforms" if the price is something as devastating to the businesses PMAA represents as are the excise tax provisions of the tax reform package being considered by the Finance Committee.

PMAA would like to explain to the Committee the nature of an independent marketer's business and the impact on that business of the excise tax provisions.

The Independent Marketer:

Independent petroleum marketers sold over 51 billion gallons of gasoline and 14 billion gallons of diesel fuel in 1984. This product is sold in several different ways at both the wholesale and retail levels.

Marketers buy their product from refiners and transport it from the refinery or pipeline terminal to their own bulk storage areas. From these bulk storage areas, the marketer transports product to his wholesale and retail customers. PMAA estimates that marketers sell on the average 30 percent of their gasoline through retail service stations they own and operate; 35 percent to independent service station dealers and 30 percent to bulk end user customers such as farmers, state and local governments, truck and taxi fleets, the federal government and many others.

Many marketers have producer licenses under the IRS code and thus collect and remit the federal excise tax on gasoline to the federal government. PMAA's conservative estimate is that over half the marketers in the United States,selling over 60 percent of the gallons, have chosen to collect and remit the federal gasoline excise taxes. This means that marketers remit over $2.7 billion annually to the federal government on sales of approximately 31 billion gallons.

With gasoline excise taxes, marketers can, and some do, elect not to collect the federal excise tax, but rather, pay it directly to their supplier. The major supplier then remits the tax to the government. Most marketers, however, choose to pay the tax directly to the federal government for several reasons.

One of the prime reasons is that marketers serve many diverse customers, some of whom are exempt from paying the federal excise tax. Such customers would include commercial fishermen, local school districts, other municipal governmental divisions, state governments, the National Guard and several others. If marketers were unable to sell these customers on a tax exempt basis, a different mechanism would have to be created which would allow them to receive a refund for those excise taxes from the federal government. This would create a greater level of paperwork for such entities, and they may instead decide to purchase directly from someone (i.e. a major supplier) that could sell gasoline on a tax exempt basis. This could create a substantial loss of business for many marketers. In some instances, because the accounts may be small, the major supplier may be uninterested in serving these accounts.

A second reason marketers prefer to collect and remit the tax is that many blend gasoline with ethanol and thus themselves qualify for a lower excise tax rate on those blended gallons. If the marketer paid the excise tax directly to the supplier, it would remove a tremendous amount of incentive for that marketer to utilize ethanol blended fuels. Thus, only the major oil companies would be in the blended fuel business. This would lessen competition and possibly drive prices of blended fuels up for the consumer.

A third reason marketers elect to collect and remit the tax relates to the internal cash flow of their business. Marketers generally have credit lines with their banks and suppliers which allow them to purchase gasoline against those credit lines. By collecting and remitting the excise tax themselves, they are able to purchase more gallons against existing credit lines. When wholesale gasoline prices hovered near $1.00 per gallon, this meant marketers could purchase 10 percent more gallons than if they paid the tax directly to their supplier. In today's market, it means marketers can purchase nearly 18 percent more gallons. It is a significant boost to a marketer's cash flow not to have to pay the excise tax up front to a supplier, particularly in an economic climate such as today where suppliers are constantly tightening credit terms to their marketers. These increased costs experienced by marketers could necessitate yet another increase in the price of fuel to consumers.

A final reason why most marketers prefer to collect and remit the tax is that they then pay the tax on gallons sold rather than gallons purchased. This means marketers do not pay taxes on gallons which are lost due to evaporation, etc.

Despite all of these reasons, some marketers do choose to pay the tax directly to their supplier. These are usually smaller marketers where the paperwork burden imposed on collecting and remitting the tax is not worth the offsetting factors associated with paying the tax directly. These marketers may also not be in the business of selling gallons to tax exempt users or in blending ethanol. They may also have suppliers that are currently offering very favorable credit terms.

Marketers are also in many cases retailers of diesel fuel and are thus responsible for collecting and remitting the 15 cents per gallon federal excise tax on diesel fuel. PMAA believes it is safe to assume that marketers are responsible for remitting taxes on half the diesel fuel gallons they sell.

Other retailers would be responsible for remitting the remainder. This would mean that marketers remit approximately $1.1 billion to the federal government on sales of approximately 7.2 billion diesel fuel gallons. Unlike gasoline marketers, these marketers have no options with regard to diesel fuel. By law, if they are the retailer, they must collect and remit the tax to the federal government.

Since they supply many retail service station dealers, marketers have volunteered to collect and remit the diesel fuel excise tax for those dealers, thus lessening the paperwork burden on the dealer. The House passed language in HR 3838 would allow marketers to collect and remit the diesel excise tax for dealers. PMAA supports this amendment, but would prefer a provision be added which requires the dealer to substantiate that the marketer actually received the letter designating him as the collector and remitter of the tax (i.e. certified letter, etc.)

Impact of Proposed Changes:

To describe the furor over the proposed changes in the excise tax laws, PMAA can best quote from one enraged marketer in Bowling Green, Kentucky: "You couldn't do more harm to us unless you bombed our service station." While many other marketers have been less descriptive in describing the proposals, at least in written form, PMAA can honestly say that it has not seen such a negative reaction to any single proposal since the days of price and allocation controls when the head of the Federal Energy Office refused to allow marketers to pass through increased costs in the cost of goods sold.

You can understand this reaction by realizing the impact the excise tax proposals will have on the average motor fuels marketer represented by PMAA. This marketer sells approximately 10 million gallons of motor fuel per year. Let us assume that 8 million gallons are gasoline and 2 million gallons are diesel fuel. Let's further assume that 90 percent of the sales are for taxable purposes, non-exempt uses.

The non-deductibility of excise taxes provision would mean that his average marketer would now have new income of over $918,000. Assuming the top corporate rate remains at the 35 percent level proposed in the Chairman's tax reform package, this marketer would pay additional income tax of over $321,000.

This is an industry where in 1984 the average petroleum marketer earned - after taxes - less than a half cent net profit for every dollar of sales. The return on assets of this typical marketer was only 2.89 percent. (Source: 1985, Petroleum Marketing Databook.)

As an industry, PMAA estimates at a maximum 35 percent tax rate that those marketers who collect and remit taxes would be liable for over $1.2 billion in increased income taxes per year if gasoline and diesel fuel excise taxes were not deductible. This is on new taxable income of nearly $3.5 billion.

How will a marketer react to such a proposal? Let's assume for a moment he is able to pass it along to the ultimate consumer. This would increase the price of gasoline to that consumer by almost a nickel per gallon and the price of diesel fuel by over eight cents per gallon.

But can the marketer pass it on to the consumer? In theory, yes; in practicality, no! Marketers compete in virtually every market with a major supplying company. The major supplying company would experience the same new costs as the marketer, but would have a much greater flexibility in allocating those costs. This is because the major refiner can spread those increased costs over all the products that are refined from a barrel of crude oil. For example, a refiner may decide to allocate part of the costs to home heating oil or aviation fuel, thus raising the costs of those products to the consumer.

The marketer who collects and remits the tax could even end up paying part of these higher costs twice. This could occur if the refiner allocated the higher costs over all gallons sold, even those non-taxed gallons sold to marketers. For example, suppose Refiner X manufactured 100 gallons of gasoline, 50 gallons of which he remitted the tax on directly and 50 gallons of which he sold to marketers who remitted the tax. On the 50 gallons Refiner X remits the tax on, his costs as a result of the non-deductibility of excise taxes, increases by 5 cents per gallon, or $2.50 total. Rather than increase his price 5 cents on 50 gallons, he may increase it 2.5 cents on the full 100 gallons. The marketers buying their 50 gallons from Refiner X would then be faced not only with the 5 cents higher costs they would face as a result of non-deductibility, but also the extra 2.5 cents passed through by Refiner X, for a total of 7.5 cents.

In areas where the marketer and Refiner X compete for customers, Refiner X would have a cost advantage of as much as 5 cents per gallon (7.5 cents - 2.5

cents = 5 cents). This advantage would be greater if Refiner X allocated part of its costs on heating oil, aviation gasoline or other products.

The only alternative for marketers, at least as far as gasoline is concerned, is to pay the tax directly to the supplier in which case the full impact of the tax would be borne by the consumer. This would not be an acceptable solution for the reasons enumerated above. It could jeopardize their ability to supply many customers that are now exempt from the federal excise tax on gasoline; it would take marketers out of the ethanol blending business completely; and it would seriously damage a marketer's cash flow.

The typical 10 million gallon a year marketer discussed above would need an additional $42,500 in cash flow to meet this new obligation. At an interest rate of 10 percent, it would cost this marketer an additional $4,250 per year. As an industry, PMAA estimates that marketers would need more than $115 million in increased cash flow at a cost of approximately $11.5 million per year at interest rates of 10 percent. These are additional costs either to be absorbed by the marketer, or market conditions permitting, to be passed through to the consumer.

The other major provision in the excise tax proposal is that excise taxes would be indexed and would rise in the future. While the summaries which PMAA has reviewed are not clear on what would trigger the escalation, we will assume it would be the Consumer Price Index and that the excise tax would be adjusted annually.

This, too, would increase the price of product to consumers and would create problems for independent marketers. Assuming, for example, the CPI increased by 5 percent in the first year after implementation of this proposal, this would increase the excise tax on gasoline by 0.45 cents per gallon.

Gasoline marketing is unique in many ways, but one of the most significant differences is that consumers can ride by a service station and see the price of product in numbers which are often over a foot high. In most instances, these numbers are expressed in 9/10 gallon increments, i.e. 89.9 cents per gallon. An increase in the excise tax of 0.45 cents per gallon would theoretically raise the price to 90.35 cents per gallon. However, one of two things would happen. In those markets where competitive conditions would allow, the price would rise not to 90.35 cents per gallon, but to 90.9 cent per gallon, meaning an additional .55 cents per gallon cost to the consumer. In many markets, the competitive conditions would not allow such a pass through and the price would remain 89.9 cents. The marketer would be forced to absorb the .45 cents per gallon which, ironically, as indicated earlier, is approximately what the net income after taxes was for the average marketer for every dollar of sales.

Other questions are also raised by this escalation proposal. Where is the higher revenue gained in each escalation going to be allocated? Presumably, since it is being used to offset other tax breaks provided in the tax reform package, it will go to general revenues. This is a major departure in that for the first time excise tax collections will not go into the highway trust fund, but into general revenues. Where will future funds be derived for the highway trust fund? Even higher excise tax increases?

Summary and Conclusions:

It is easy to see, Mr. Chairman, why the marketer in Bowling Green, Kentucky believed that you couldn't do more harm by bombing his service stations. At worst, you have taken a group of small businessmen who supply the petroleum product needs of millions of drivers and homeowners; of thousands of farmers; of countless municipal governments; of thousands of other small businesses and increased their federal income tax liability by over $1.2 billion per year by saying they must pay income tax on excise taxes they collect and remit to the federal government. At best you have told these marketers they will incur new income taxes of nearly $448 million on diesel fuel excise taxes they are required to collect and remit to the government, plus increase the cash flow demands on these companies of $115 million because they will be paying the gasoline excise tax to their supplier in advance.

All of this is being done in the name of "tax reform" and does not contribute whatsoever to reducing the federal deficit. If these excise tax provisions are the price of tax reform, then PMAA and the 11,000 small businesses it represents says unequivocably that it is opposed. PMAA's idea of tax reform is not to see tax breaks passed out to some while the revenue to compensate for these tax breaks is generated on the backs of small businessmen.

In summary, Mr. Chairman, PMAA is strongly opposed to the changes you propose in the way motor fuel excise taxes are to be considered for purposes of income taxes as well as changes in the way the excise taxes are collected and remitted. Current law is not a loophole. Federal excise taxes are a legitimate cost of doing business. Moreover, non-deductibility results in a regressive tax increase which will fall most heavily on those least able to pay it; it is an arbitrary consumption tax increase; it is inconsistent with the original purpose of the motor fuels excise tax - which is to fund the Highway Trust Fund; it penalizes taxpayers who have acted as government collection agents; and it also raises serious constitutional questions.

PMAA again commends the Chairman for his willingness to hold these hearings, but we strongly urge that excise tax provisions of the Senate version of the tax reform package be eliminated.

Thank you and PMAA will be happy to respond to any questions from the committee.

Statement In Opposition To
Increase in Excise Taxes on Consumer Products
Submitted on Behalf of Philip Morris Companies Inc.

By Hamish Maxwell
Chairman of the Board and Chief Executive Officer
For the Record of the
Hearing on Excise Taxes Before The
Committee on Finance, United States Senate
April 21, 1986

Mr. Chairman and Members of the Committee, I thank you for the opportunity to present this statement on behalf of Philip Morris Companies Inc., of which I am Chairman of the Board and Chief Executive Officer. We are opposed to an increase in selective excise taxes on consumer products in any form, whether the increase is accomplished through denial of income tax deductions for excise taxes, through an indexing mechanism to reflect price increases, or through any other direct or indirect means.

Philip Morris Companies Inc. is among the world's largest manufacturers and marketers of tobacco, beer, and food products. In addition to being the largest producer of cigarettes in the United States with additional markets in more than 170 countries and territories, the Philip Morris family includes Miller Brewing Company and General Foods Corporation. The 1985 operating revenues of the Philip Morris family were $16 billion. Philip Morris employs 73,000 people in the United States, including 20,000 related to tobacco and 11,000 to brewing. Overall, beer and tobacco create enormous economic and pleasurable benefits for 80 million beer drinkers and 60 million smokers. According to a study by Chase Econometrics,* the tobacco industry generated 710,000 jobs directly and another 1.6 million indirectly. It accounted for $31.5 billion of GNP in 1983 and tax revenues in excess of $13 billion. The beer industry directly employs nearly 190,000 people and creates an even greater number of indirect jobs. These employment figures include a quarter of a million farm families who produce the 1.3 billion pounds of tobacco and the 7.6 billion pounds of barley, hops, corn and rice used in these industries each year.

Philip Morris was an early and vigorous supporter of the Administration's tax reform proposals. We remain committed to tax reform in principle and substance. The principles of tax reform enunciated by Secretary of the Treasury Baker are to eliminate use of the tax system as a means "to favor one taxpayer over another, to favor one industry over another, to favor one form of consumption over another, or to favor one investment over another." In other words, the objectives of tax reform are to eliminate preferred tax treatment of some taxpayers, to distribute the tax burden more equitably among all taxpayers and to make the tax system more neutral with regard to business investment decisions. It was proposed that the additional income tax revenues generated from accomplishment of these objectives would be returned dollar-for-dollar to American taxpayers through a substantial reduction in tax rates for individuals and businesses.

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* The Economic Impact of the Tobacco Industry on the United States Economy, Chase Econometrics, January, 1986.

In March, Chairman Packwood, in order to make his income tax bill "revenue neutral" while retaining or improving many special tax benefits for selected industries, called for a massive increase in federal excise taxes on consumer products, especially on those consumed by tens of millions of lower and middle-income individuals. This would amount to the largest excise tax increase in our history. In this manner he proposed to raise $77 billion in revenue to offset other revenue losing changes advanced as part of his tax package.

I. THE SENATE COMMITTEE ON FINANCE SHOULD REJECT ANY FORM OF SELECTIVE EXCISE TAX INCREASE ON CONSUMER PRODUCTS

We believe the Senate Finance Committee should reject the Chairman's March proposals, or any other proposal, that would raise selected federal excise taxes on consumer products. We believe the Senate Finance Committee should reject such excise tax increases, whether they would be effected through direct or indirect means, for the following reasons:

- The proposals contradict the President's stated objectives of tax reform in that they are inequitable and harmful to the economy;
- The proposals would be inflationary;

- The proposals constitute a regressive tax increase for low and moderate income consumers; and
- The proposals adversely impact farmers, suppliers, producers and labor.

The Proposals Contradict the Stated Objectives of Tax Reform

Massive increases in regressive federal excise taxes are not tax reform from any political perspective, either Republican or Democrat. The proposals to increase selective excise taxes imposed on consumer products are inconsistent with each of the objectives of tax reform. Instead of reducing special tax breaks to pay for a reduction in income tax rates benefiting everyone, the Chairman's excise tax proposals would levy a huge increase on millions of individuals to pay for a continuation of others' tax breaks. Rather than eliminating the preferred treatment of some taxpayers, distributing the tax burden more equitably among all and making the tax system more neutral with regard to business investment decisions, this new kind of "tax reform" would burden selected products and services, would not distribute the tax burden equitably and would distort resource allocation. Philip Morris is already among the highest effective rate income taxpayers in the corporate community. From any reasonable perspective, the proposal would seriously undermine the goal of economic neutrality, which is a major objective of the President's current tax reform effort.

Furthermore, the effect of the Chairman's proposal would be to take from one pocket of a taxpayer money that was promised to his other pocket through a cut in income taxes. This approach undercuts substantial tax relief promised to millions of low and moderate income Americans.

Assistant Treasury Secretary Mentz, in his statement before the Committee on April 21, indicated that key elements of tax reform are a maximum tax rate no higher than 35 percent and tax brackets that reduce taxes for middle-income Americans. However, the President has espoused tax reform to the American public on the basis that special tax breaks provided to some taxpayers require other taxpayers to pay more tax. His thesis was that elimination of many of these tax breaks would enable tax rates to be reduced. His original proposals were modeled to achieve this result. The House made a similar effort. Neither the President nor Treasury had suggested that income tax rates are too high because regressive excise taxes on consumer products are too low. Quite the contrary, the original Treasury study rejected consumption taxes, such as the excise taxes proposed here.

We are, therefore, dismayed to see a proposal for an increase in selective excise taxes on consumer products (rather than their reduction or elimination) surface under the label of "tax reform", particularly when the increase is targeted primarily to three items -- tobacco, alcohol and fuels -- that are already among the highest taxed items in America.

Inflationary Effects on Consumers

The proposals to increase selective excise taxes on consumer products are bad economic policy. They would be inflationary, resulting in a dramatic increase in prices of products on which the excise tax burden now falls. Virtually everyone, including Treasury, believes that increased excise taxes would be passed on to consumers in the form of higher prices. Based upon the consequences of the major increase in excise taxes on cigarettes in 1983, Philip Morris has concluded that all of the proposed increase in excise taxes on tobacco products and beer would be passed on by companies in these industries to consumers through price increases in the affected products. According to the Tobacco Institute economists, over the first five years the proposal would cause additional consumer expenditures of about $29 billion for cigarettes. Over the same period the proposal is estimated to cause additional consumer expenditures of approximately $10 billion for beer. At retail, the initial impact of the proposal on the consumer would be a price increase in 1987 of $1.60 per carton (16¢ per pack) of cigarettes growing to $2.60 (26¢ per pack) by 1991, and a price increase in 1987 of $.92 per case of beer growing to $1.71 per case in 1991. A study by Chase Econometrics[*] of the entire package proposed by Chairman Packwood found that over the five years through 1991, it would raise the overall consumer price level 0.7% in 1987, rising to 1.4% by 1991.

Regressive Aspects of Proposals

An analysis of the federal excise tax and tariff proposals recently prepared by deSeve Economics[**] concludes that excise tax increases would be borne disproportionately by low income taxpayers. The study found that households with incomes of less than $10,000, for example, would pay 8% of excise tax and tariff increases but account for only 3% of all income. Households with incomes of less than $20,000 account for only 12% of all income but would pay 23% of excise tax and tariff increases, while households with incomes above $100,000, which account for 14% of all incomes, would pay only 6% of the excise tax and tariff increases. The report concludes that the excise tax and tariff provisions would wipe out almost half of the income tax reduction promised by the plan. High bracket individuals would lose only 6% of their income tax reduction while those in the lowest brackets would lose more than 60% of theirs. Thus, the 77% income tax reduction promised to those in the lowest bracket would shrink to only a 13% reduction in tax liability when excise tax and tariff increases are taken into account.

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[*] A Quantitative Analysis of the Packwood Tax Reform Proposal, Chase Econometrics, April 10, 1986.

[**] An Analysis of the Federal Excise Tax and Tariff Proposals in the Senate Finance Committee, deSeve Economics, April, 1986.

The rationalizations offered to suggest that excise taxes are not really as regressive as they appear are lacking in merit. Assistant Secretary Mentz suggested in his April 21 statement that excise taxes "appear to be more regressive than they would if lifetime consumption and income data were relied upon". This is a novel approach for concluding that excise taxes are not regressive. It is also contrary to the view expressed in the Treasury's study of the subject in drafting "Treasury I". Mr. Mentz's hypothesis suggests that since young families and retired people spend a higher proportion of their income than do middle-age families, over a lifetime everything works out even. Does anyone seriously believe that an elderly low-income person will not find increased excise taxes regressive because he had higher income before he retired? Does anyone seriously believe that young families will not find increased excise taxes regressive because they can look forward to the statistical probability of higher income levels at some future point in their lives?

Mr. Mentz further suggests that increases in selective taxes are not regressive because individuals who do not choose to consume the taxed goods do not have a tax burden. The factor of choice does not alter in any way the basic fact that the increased tax will be very regressive to the low and moderate income people who in fact do consume the taxed articles.

Use of a low-income tax credit to address the problem of regressivity does not provide a feasible solution for several reasons. First, it would be very costly and would therefore significantly reduce the tax revenue intended to be raised from the proposal. Second, the credit would not benefit those who pay no income tax, unless the credit were made refundable. Finally, correctly targeting the credit to benefit only the intended victims of the increased selective excise tax would be an impossible administrative task and add to the complexity of the income tax system.

Impact on Farmers, Suppliers, Producers and Labor

Although increases in selective excise taxes on consumer products would be inflationary and thus damaging to consumers, they would also severely and adversely impact producers, their labor force and shareholders, and farmers, suppliers and distributors. For example, the last increase in cigarette excise taxes in January, 1983 (in which the federal cigarette excise tax was doubled) has caused to date at least a $2.5 billion loss of retail sales. Industry-wide, the increase is estimated to have resulted in a loss of job opportunities for nearly 15,000 workers. Further, the 1983 increase in cigarette excise taxes undoubtedly exacerbated the farm surplus problem, which is currently at a level of 1-1/4 billion pounds of tobacco. It is estimated that the 1983 excise tax increase resulted in lost sales of 29.6 million pounds of tobacco per annum. Chase Econometrics estimates that during the five-year period through 1991, the Chairman's entire package would reduce the number of job opportunities by an average of 691,000 per year, a cumulative man-year loss of over 3.4 million.*

It is manifestly unfair for a substantial, disproportionate tax burden to be placed on a narrowly targeted segment of the American public to pay for lower income tax rates and tax benefits enjoyed by others. This is true whether the targeted segments turn out to be the farmers, suppliers, labor force and owners of the selected producer or the consumers of its product.

Additional Points

In the April 21 statement of Assistant Secretary Mentz, he suggested several inappropriate criteria as excuses for selectively raising excise taxes. He first asserted that it is appropriate to increase the rate of excise tax if the price of an article does not reflect the "social cost" associated with that product. Although he indicates that tobacco products and alcoholic beverages fall in this category, he provides no usable criteria for measurement of the "social cost" for these or any other product and his testimony implies that only a few products and activities fall in this category. We contest the notion that beer and tobacco create any scientifically measurable "social costs". They do create enormous economic and pleasurable benefits for 80 million beer drinkers and 60 million smokers. According to the January, 1986 study by Chase Econometrics, the tobacco industry generated 710,000 jobs directly and another 1.6 million indirectly. It accounted for $31.5 billion of GNP in 1983 and tax revenues in excess of $13 billion. The beer industry directly employs nearly 190,000 people and creates an even greater number of indirect jobs. Moreover, there are few if any products and activities for which one cannot assert "social costs". This type of so-called test does not advance true tax reform, which had as a purpose the elimination of subjective evaluations of different industries which have encumbered the tax code with numerous exceptions to the detriment of free economic decision making.

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* A Quantitative Analysis of the Packwood Tax Reform Proposal, Chase Econometrics, April 10, 1986.

Mr. Mentz also suggested that it is appropriate to raise excise taxes where demand for a product is not responsive to price changes. It is doubtful that any such product or service exists in the real world. Experience in the United Kingdom proves that these products are responsive to excise tax increases. Moreover, even if these products were totally inelastic, significant tax increases on these products would cause less funds to be available for consumption of other products such as food, clothing and housing.

From a broader perspective, the viewpoints expressed by Mr. Mentz are totally inconsistent with the position expressed many times by the President that consumer choices should be determined by the market place and not by the government.

The Senate Committee on Finance Has Previously Rejected Selective Excise Taxes on Consumer Products for the Reasons Expressed Here

The Senate Committee on Finance in 1965 wisely recognized the undesirability of imposing selective excise taxes on consumer products as a fair way of raising revenue. In the Senate Finance Committee Report accompanying the 1965 legislation which repealed a panoply of selective excise taxes burdening consumer products, the Committee condemned their use as a "source of undesirable discrimination." The Committee determined that "these selective excise taxes tend to reduce sales and therefore reduce incomes and jobs in the industries which produce the taxed goods. In these ways selective excise taxation results in arbitrary and undesirable distortions in the allocation of resources and in this manner interferes with the free play of competitive markets." The Committee further concluded that excise taxes "are regressive in their impact, absorbing a larger share of the income of low-income persons than of those with higher incomes." The Committee's unequivocal and accurate criticisms of selective excise taxes are as appropriate today as they were in 1965; unlike some of the targeted products, the deficiencies of selective excise taxes on consumer products do not improve with age.

Conclusion

The millions of voters who will have to pay for this kind of false "tax reform" will readily understand its true nature. The Chairman's proposal would raise the price of beer, phone calls, gas, oil, liquor, air travel, wine, coal, boating, tobacco products, tires, and transportation costs of all consumer products. The number of individuals paying these increased prices would be very large, including 80 million consumers of beer and 60 million consumers of tobacco products. Indeed, the firm of Burson-Marsteller recently conducted a nationally projectable survey* of adult Americans in an effort to understand their attitudes toward, and their willingness to accept, this proposal. The survey concludes that 44% were opposed to the proposal, with only 19% expressing any degree of support for it. Americans over age 50 and lower income Americans expressed higher levels of opposition.

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* Americans Evaluate Senator Packwood's Tax Proposals, Burson-Marsteller, March, 1986.

Thus, the American public is not deceived into believing that this constitutes "tax reform". American industry and its labor force do not believe that this constitutes "tax reform". We urge that the Members of this Committee reject the characterization of this package as "tax reform".

II. DEFICIENCIES OF THE PARTICULAR TECHNIQUES PROPOSED FOR INCREASING SELECTIVE EXCISE TAXES

The techniques proposed as a means of raising excise taxes are particularly questionable. The proposal for indexing federal excise taxes on tobacco, alcohol and fuels, in addition to creating many technical problems as to application of the proposal, would heighten the previously described negative consequences to consumers and producers. The proposal to disallow income tax deductions for the excise tax or tariff portion of the costs incurred by business in producing and providing products and services is bad income tax policy, has possible constitutional infirmities, and could place domestic products at a competitive disadvantage with imports.

A. Indexing Federal Excise Rates for Alcohol and Tobacco Products and Fuels to Reflect Price Changes

Indexing federal excise tax rates on alcohol, tobacco products and fuels is simply a means to increase excise taxes on selected consumer products. Accordingly, the proposal suffers from all of the infirmities previously described in this Statement, and should be rejected by this Committee. Moreover, tying the rate of tax on these three items to future consumer price increases heightens the adverse features inherent in selective excise taxes on consumer products, in that the price adjustment feature tends to cause the regressive and economically distortive features of the tax to become permanent, rather than soften with time.

At the April 21 hearings, Assistant Secretary Mentz suggested that indexing the excise tax rates on these products is consistent with the concept of indexing income tax rate brackets and depreciation rates. There is no correlation between indexing income tax rate brackets and depreciation and the indexing of federal excise taxes. The effect of indexing income tax rate brackets and depreciation is to prevent automatic increases in federal revenues (and consequent increases in government spending) with each round of inflation. The effect of this proposal to index excise taxes is to insure automatic increases in federal revenues (and consequent increases in government spending) with each round of inflation. One of the principal reasons advanced for income tax rate bracket indexing is that the government should not be the beneficiary of increased revenue from inflation that it has, at least in part, created. Another reason advanced for income tax rate bracket indexing is that automatic increases in federal revenue create another round of automatic increases in government spending. Thus, the indexing of federal excise taxes to price increases cannot in any sense be viewed as a corollary of indexing income rate brackets and depreciation. If anything, the reasons advanced in support of indexing income rate brackets and depreciation constitute strong grounds for not indexing excise tax rates.

It would also be unfair to index the rate of the manufacturing excise tax on tobacco products and alcoholic beverages to consumer price levels, since a substantial portion of the consumer prices of such products is attributable to the Federal excise tax and various state taxes.

Most importantly, the indexing proposal would remove from Congress its legislative prerogative to review all appropriate factors before increasing tax rates. Assistant Secretary Mentz, in his April 21 testimony, correctly observed that this is a difficult process. Automatic tax increases are a poor substitute for Congressional determinations.

B. The Idea to Disallow Income Tax Deductions for the Excise Tax or Tariff Portion of the Cost Incurred by Business in Producing and Providing Products and Services

1. The Proposal is Bad Income Tax Policy

No sound tax policy justification for the proposal exists. Our income tax system rests upon the fundamental principle that the appropriate tax base is net income, not gross income. That means that all costs incurred in the conduct of a trade or business or in the production of income must be subtracted from gross receipts or deducted from gross income to arrive at taxable income upon which the income tax is computed. Thus, for example, deductions for the cost of labor and raw materials have always been allowed by the income tax law as a cost of goods sold since its original enactment in 1913. The proposal to disallow income tax deductions for the excise tax or tariff portion of the costs of products or services produced or purchased by businesses flies in the face of this fundamental tax principle. Excise taxes are not tax preferences, but are federally mandated, involuntary cash collections on behalf of the U.S. government.

The one reason that has been advanced to justify the proposal is that the allowance of a deduction for excise tax collections results in an effective rate which is less than the nominal rate. This premise is fallacious because it fails to take into account the taxation of the portion of sales revenue which is essentially an excise tax collection. Philip Morris, for example, fully passes the excise taxes imposed on its activities on to consumers in the form of higher prices. Such increases in price are, of course, includable in the taxable income of the seller.

A few simple progressive examples clearly illustrate that the income tax deduction for the excise tax or tariff portion of the cost of sales does not reduce the effective rate of the federal excise tax; rather, a denial of such deduction will cause the effective rate of the excise tax to be greater than the nominal rate.

> Example 1. Assume an income tax rate of 35%, a consumer product with a cost to the Seller of $100, and a selling price to an individual, nonbusiness consumer of $110. Assume further that no excise tax is imposed on the product. The income from the transaction to the Seller is thus $10.
>
> Income tax revenue -- $3.50
> Excise tax revenue -- 0
>
> Example 2. Assume the same facts as Example 1, except that a $10 excise tax on the product is imposed directly on the consumer. Assume further that Seller is required by law to collect the tax on behalf of the federal government and pay the amount over to the government. The Seller, accordingly, still has a $10 gain on the transaction.
>
> Income tax revenue -- $ 3.50
> Excise tax revenue -- $10.00
>
> Total revenue $13.50
>
> Example 3. Assume the same facts as Example 2, except that the tax is imposed directly on the Seller and the Seller increases the price of the article to reflect the tax. Under existing law, Seller still has $10 gain on the transaction ($120 selling price less $110 cost of goods sold).
>
> Income tax revenue -- $ 3.50
> Excise tax revenue -- $10.00
>
> Total revenue $13.50

Example 4. Same as Example 3. Assume enactment of the proposal so that no deduction is allowed the Seller for the excise tax portion of his cost of goods sold. Although the Seller still has only $10 of gain from the transaction, his taxable income from the transaction is artificially increased to $20.

Income tax revenue --	$ 7.00
Excise tax revenue --	$10.00
Total revenue	$17.00

In this example, the nominal excise tax rate has been increased by 35% through the indirect means of a tax on artificially created income. The effective tax rate would be increased even more if the Seller in Example 4 further increased his price to reflect the additional tax created by the loss of the deduction. For the Seller to be made whole, he would have to increase his price by approximately 154% of the amount of additional Federal income tax. In such case, his price under Example 4 would be $125.39, his taxable income would be $25.39 and the income tax on the transaction would be $8.89. The effective excise tax rate would be 154% of the nominal rate.

The price would rise still further if state and local income taxes were factored into the equation on the assumption that the states followed Federal income tax law in determining taxable income. Assuming a 6% nominal state tax rate and an effective rate of 4% after Federal income tax deduction, the price adjustment would be approximately 183% of the amount of the additional Federal income tax in order for the Seller to be made whole (a price of $126.40 under the facts of Example 4).

Thus, it should be obvious that to the extent that prices are increased to reflect the excise tax, the allowance of the deduction does not reduce the effective rate of the excise tax to less than its nominal rate; to the contrary, the proposal to disallow the deduction would increase the effective rate of the excise rate or tariff above its nominal rate.

2. The Proposal Has Possible Constitutional Infirmities

Congress' power to levy an income tax derives from the Sixteenth Amendment which states: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

There is substantial authority that the Sixteenth Amendment does not authorize Congress to impose a tax on gross receipts. Since Congress' power under the Sixteenth Amendment is limited to taxing gains, there is accordingly a strong constitutional argument that Congress cannot tax the gross receipts realized on the manufacture and sale of a product. Rather, the Constitution demands that the income tax law must first allow a full recoupment of a business' cost of goods sold before exercising its taxing power.

We believe that it would be improvident for Congress to enact a proposal to raise $62 billion which would be so vulnerable to constitutional attack. The uncertainty to both the Federal government and companies which are excise tax collection agents for the Federal government inherent in protracted litigation challenging the constitutional validity of such a proposal would make its enactment poor tax policy.

See Appendix A for the view expressed by two prominent law firms, Shea & Gould and Sutherland, Asbill & Brennan, regarding the constitutional vulnerability of this proposal.

3. The Proposal May Violate Multilateral Trade Agreements and Tax Treaties

To the extent that the proposal would disallow the costs of goods reflected by tariffs, it is equivalent to an increase in U.S. customs duties. The proposal thereby opens the United States to the charge that it is a breach of our Multilateral Trade Agreements under GATT. Since the United States has been vigorously seeking liberalization of foreign restrictions against U.S. exports of tobacco and alcohol products, foreign governments are likely to be less receptive to these efforts if they perceive that the United States is effectively increasing its own customs duties. Furthermore, taxation under this proposal of foreign companies otherwise exempted by tax treaty may violate many of our tax treaties.

4. The Proposal Would Create Possible Competitive Advantages for Foreign Imports

If the proposal were adopted but tax treaty provisions were to override this proposal, the competitive advantage of foreign imports would seriously damage many U.S. industries. For example, the price of domestic beer would rise significantly, while imports may be exempted by treaty from these provisions.

Even if treaties did not protect an imported product, it follows from the examples under Section B.1 above that foreign businesses not otherwise subject to U.S. income taxes would not have to increase their prices as much as would be the case for income-tax paying U.S. businesses. Specifically, a business that does not otherwise pay U.S. income taxes would only have to increase prices by the amount of the minimum income tax to be made whole ($3.50 under Example 4 above), while tax-paying U.S. competitors would have to increase prices by at least 154% of the increased income tax, and often more, to achieve the same result.

Contrary to the assertion of Assistant Secretary Mentz in his April 21 statement, the proposal would place domestic products at a competitive disadvantage with imported products.

CONCLUSION

For the reasons stated above, we urge the Senate Finance Committee to reformulate its tax reform proposals in accordance with the principles for economic neutrality and growth, and to reject any proposals to increase selective excise taxes on consumer products, regardless of whether the increase would be accomplished indirectly by denial of income tax deductions or directly through flat increases or indexing.

APPENDIX A

THE SENATE FINANCE COMMITTEE CHAIRMAN'S PROPOSAL TO MAKE FEDERAL EXCISE TAXES AND TARIFFS NON-DEDUCTIBLE FOR FEDERAL INCOME TAX PURPOSES IS VULNERABLE TO CONSTITUTIONAL ATTACK

1. The Senate Finance Committee Chairman has proposed making federal excise taxes and tariffs nondeductible for federal income tax purposes, including the disallowance of these items from costs of goods sold. For the reasons that follow, we believe that it would be improvident for Congress to enact a proposal which would be vulnerable to constitutional attack. It is claimed that the excise tax and tariff provision would raise $62 billion during the next five years. But if the tax bill is to be revenue neutral, it would be unwise to subject such a substantial amount of revenue to the uncertainty inherent in protracted litigation challenging its constitutional validity.

2. Congress' power to levy an income tax derives from the Sixteenth Amendment which states: "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." The Sixteenth Amendment creates an exception to the general rule contained in Article I, Section 2, clause 3 of the Constitution which provides that direct taxes must be apportioned among the states.

There is substantial authority suggesting that the Sixteenth Amendment does not authorize Congress to impose a tax on gross receipts on the manufacture and sale of a product. Thus, in Eisner v. Macomber, 252 U.S. 189, 207 (1920), the Supreme Court stated that the term "income" used in the Sixteenth Amendment means "'the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets" (emphasis supplied). Congress' power under the Sixteenth Amendment is limited to taxing gains or profits. As the Supreme Court long ago observed, the Constitution demands that the income tax law must first allow a full recoupment of a business' capital costs or cost of goods sold in computing profit or gain for federal income tax purposes. See, e.g., Doyle v. Mitchell Brothers Co., 247 U.S. 179, 185 (1985). See also, e.g., Commissioner v. Meyer, 139 F.2d 256, 258-259 (6th Cir. 1943). As a result, Congress' power to levy an income tax is limited by the principle that a full recoupment of such capital costs must be allowed.

This principle was explicitly ratified by the Tax Court in Sullenger v. Commissioner, 11 T.C. 1076, 1077 (1948), where the court stated: "Section 23 makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory" (emphasis supplied). See also Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952).

3. There are, to be sure, limited instances in which the federal income tax law denies a deduction for actual outlays or expenditures. See, *e.g.*, Pedone v. United States, 151 F.Supp. 288 (Ct. Cl. 1957). These instances involved situations where the deduction was claimed for payments in excess of authorized price or wage limitations or other unreasonable compensation, fines or penalties, or other illegal expenses. But these unusual situations, where it was at least arguable that public policies dictated disallowance of income tax deductions, cannot be assimilated to federal excise tax or tariff payments. Such imposts are mandatorily imposed by the federal government upon legitimate business transactions. Federal excise taxes and tariffs are just as much a part of the cost of goods sold of a producer or manufacturer as the cost of raw material or direct labor. See, *e.g.*, Liggett & Myers Tobacco Co. v. United States, 299 U.S. 383 (1937).

4. Congress recognized this fundamental constitutional distinction when it added Section 280E to the Internal Revenue Code in 1982. That provision disallows the income tax deductions for amounts paid or incurred in illegal trafficking in drugs. But in adding that provision to the Code, Congress carefully noted that "[t]o preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill" (emphasis supplied). S. Rep. No. 494, 97 Cong., 2d Sess. 309 (1982). See also Staff of the Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 264 (Comm. Print 1982).

5. If excise taxes and tariffs are made nondeductible from gross receipts, the resulting tax would be an unapportioned direct tax on capital and not on income within the meaning of the Sixteenth Amendment. Since the present federal income tax is a direct tax under the Supreme Court's rationale in Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895), there is strong support for the conclusion that enactment of the Chairman's proposal would result in the imposition of an unconstitutional unapportioned direct tax on capital.

SHEA & GOULD

SUTHERLAND, ASBILL & BRENNAN

April 11, 1986

UNIVERSITY OF COLORADO, BOULDER
Department of Economics

April 29, 1986

Ms. Betty Scott-Boom
Committee on Finance
SD-219 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Ms. Scott-Boom,

Enclosed is my written statement for inclusion in the hearing record for the Senate Finance Committee on Packwood's Federal Excise and Tariffs Proposals. I want to thank you for the opportunity to present my views on the proposal.

Sincerely yours,

Barry W. Poulson
Chairman

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Senator Packwood's tax proposal will not meet the objectives for tax reform contained in both the Administration's original proposal and the reform bill passed by the House of Representatives. A major objective of these latter proposals is a significant reduction in the tax burden on lower and middle income families. A recent analysis of the impact of the Packwood Proposal by Citizens for Tax Justice, utilizing the Muth Regional Policy Impact Simulator, shows that the burden of the proposed increases in excise taxes will fall primarily on those least able to pay--especially young families and elderly households. That study estimates that the typical family stands to lose an average of 49% of the tax relief it would receive under the House tax proposal; and families earning under $11,000 a year would lose 79% of that tax relief. However, families earning more than $84,000 a year would keep almost 90% of their tax reductions.

In his testimony before this committee Roger Mentz notes that the distributional effects of the Packwood Proposal are regressive; however, he qualifies this by citing a study showing that excise taxes are less regressive when calculated on an annual basis. The reason for this difference is that in years when families have unusually low incomes, e.g., young families and elderly households, or households impacted by illness or unemployment, they spend a larger share of their income for consumption compared to other years in which they have normal expenditures out of 'normal' lifetime income. From the standpoint of society it is important to know that excise taxes are less regressive for lifetime income than for annual income. But for low income families who must bear the burden of these excise taxes in the years when their income is depressed, it is small consolation to know that excise taxes will be less regressive over their lifetime income. I should amphasize that excise taxes are regressive whether we use lifetime income or annual income. Mr. Mentz's statements seem to be designed to deflect us from the major issue, i.e., the Packwood Proposal to raise excise taxes will shift a greater share of the tax burden to low and middle income families, compared to the Administration and House proposals.

Mr. Mentz also lends his support to Senator Packwood's proposal to adjust federal excise taxes to reflect price changes. Such indexation would exacerbate the regressive impact of these taxes. The Citizens for Tax Justice study notes that a 21 cent a gallon increase in federal excise taxes on gasoline would cost the average American family $158 a year. Families earning less than $11,000 a year would pay six times as great a share of their incomes in higher gas taxes, compared to a family earning more than $84,000 a year. Indexing these taxes for the rate of inflation permits the federal government to raise taxes automatically without a specific act of Congress and corresponding accountability to American families impacted by these taxes.

Mr. Mentz offers several justifications for the proposed increase in excise taxes contained in the Packwood Proposal: to internalize external costs associated with producing or consuming a good, to cover government benefits to the users of the good, or to raise revenue with minimal distortion of economic behavior. Increasing excise taxes and indexing those taxes for the rate of inflation is a very inefficient means to accomplish these social objectives. The costs associated with the consumption of alcoholic beverages and cigarettes are primarily private costs rather than social costs. The external costs associated with the consumption of gasoline are best solved through measures designed to reduce the amount of pollution, rather than through excise taxes to reduce the consumption of gasoline. The fact is that we do not have data and analyses of externalities associated with the consumption and production of these commodities, nor of the impact of higher excise taxes on reducing externalities, which would justify Mr. Mentz's position on the Packwood Proposal. On the other hand, we have ample evidence that higher excise taxes would significantly distort resource allocation in the economy. The Citizens for Tax Justice study estimates that 11,640 jobs would be lost, with thirty-two states ending up as job losers. Job losses would occur primarily in wholesaling and retailing, but also in a wide range of other industries including automobile and transportation services, the beverage industry, and containers.

Mr. Mentz concludes his testimony arguing that "if sufficient base broadening measures are not adopted, and if the President's tax reform objectives are otherwise met, the Administration could support excise and related tax proposals as part of a revenue-neutral tax reform bill, provided that a justification exists for increasing the level of the particular tax." The evidence in the Citizens for Tax Justice study leads one to conclude that there is not justification for the Packwood Proposal to raise excise taxes and that the proposal is in conflict with the President's stated objective to reduce the tax burden on low and middle income famílieis. I conclude that we should reject the Packwood Proposal and return to earlier tax reform initiatives from the Administration and the House of Representatives which would, in fact, broaden the base for the tax system. Those earlier proposals avoid the cost of a number of corporate loopholes that are contained in the Packwood Proposal, such as accelerated depreciation, oil and gas preferences, tax subsidies for timber interests, foreign tax loopholes, and tax breaks for defense contractors.

In the final analysis the rationale for the Packwood Proposal is that the cost of these tax loopholes can be passed along to millions of taxpayers through 'hidden' excise taxes, and the taxpaying public as a whole has neither the resources nor the incentive to oppose this legislation. The issue of tax reform is too important to be left to these vagaries of the political process. The Packwood Proposal should be rejected and Congress should return to a tax proposal more consistent with the stated objectives in the original proposals for a true tax 'reform.'

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April 17, 1986

MEMORANDUM

We have been asked by R.J. Reynolds Industries, Inc. to examine the constitutionality of the proposal of the Senate Finance Committee's staff that federal excise taxes and tariffs be nondeductible for income tax purposes. We conclude from our examination that the proposal is vulnerable to attack under the United States Constitution.

Art. I, §2, cl. 3 and Art. I, §9, cl. 4 require that any direct tax be apportioned. In response to the Supreme Court's decision in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), the Sixteenth Amendment was adopted to modify or clarify the effect of Article I on the taxation of "income." The Sixteenth Amendment provides as follows:

> The Congress shall have power to lay and collect taxes *on incomes*, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration. (emphasis added)

It is fairly well established that this provision does not authorize Congress to levy direct taxes on amounts received as a return of capital. In *Eisner* v. *Macomber*, 252 U.S. 189 (1920), the Court defined "income" as the gain or profit derived "from capital, labor, or from both combined" or "through a sale or conversion of capital assets." *Id.* at 207. Similarly, in *Doyle* v. *Mitchell Bros.*, 247 U.S. 179 (1918), the Court noted that an income tax does not "tax property as such, or the mere conversion of property, but . . . the gainful returns from . . . business operations and property." *Id.* at 183. With respect to computing such "gainful returns," the Court stated:

> In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

Id. at 185. See Southern Pacific Co. v. Lowe, 247 U.S. 330, 335 (1918), in which the Court said: "We must reject . . . the broad contention submitted in behalf of the government that all receipts -- everything that comes in -- are income within the proper definition of the term 'gross income,' and that the entire proceeds of a conversion of capital assets, in whatever form and under whatever circumstances accomplished, should be treated as gross income." See also Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921); Goodrich v. Edwards, 255 U.S. 527, 535 (1921); 1 Mertens, Law of Federal Income Taxation §§ 5.06, 5.10; R. Magill, Taxable Income 359 (rev. ed. 1945).

In short, there is powerful authority for the proposition that Congress lacks the power under Article I of the Constitution, notwithstanding the Sixteenth Amendment, to impose an unapportioned, direct tax on gross receipts without permitting the taxpayer to exclude that portion of its receipts which actually constitutes a return of capital. The Service and the courts have long recognized that capital costs reflected in gross receipts, such as a manufacturer's or merchandiser's cost of goods sold, should be subtracted from the taxpayer's gross receipts in computing gross income. Cost of goods sold thus is an above-the-line exclusion, rather than a deduction from gross income which helps establish the taxpayer's net or taxable income. The allowance of deductions may "depend[] upon legislative grace," New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934), but an exclusion for the cost of goods may well be constitutionally compelled.

The Supreme Court has never squarely addressed this constitutional issue. The decisions of a number of lower courts, however, provide guidance on the question and strong support for a constitutional challenge to the Committee staff's proposal. These cases generally involve payments or expenditures which in one respect or another were unlawful. In the seminal case of Sullenger v. Commissioner, 11 T.C. 1076 (1948), the petitioner purchased meat from wholesale firms at prices in excess of O.P.A. ceilings. The petitioner sought to exclude his entire purchase price as cost of goods sold, but the Commissioner contended that the amounts paid in excess of the price ceilings could not be subtracted. The court found for the taxpayer, reasoning as follows: "[T]he Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory." Id. at 1077. The court further found that cases or considerations involving deductions were irrelevant "since this case does not involve any deduction," but instead involved the computation of gross income.

The District Court in Maryland followed Sullenger in the case of Anderson Oldsmobile, Inc. v. Hofferbert, 102 F. Supp. 902 (1952). The taxpayer's cost of goods in that case included payments for automobiles in excess of the official ceiling prices. The court held that the income tax "is not, never has been and could not constitutionally be upon 'gross receipts'" (citing Lowe and Doyle). Id. at 905. Affirming, the Fourth Circuit held as a matter of statutory construction that the taxpayer's illegal payments for goods should be subtracted in calculating gross income. 197 F.2d 504 (1952). The Court of Appeals for the First Circuit reached the same conclusion that year in Commissioner v. Weisman, 197 F.2d 221, grounding its decision on the statute but noting that the offset for cost of goods guarantees the return of capital and thus avoids the charge that the tax is on capital rather on income. Id. at 224.

A few years later, the First Circuit issued its decision in Winkler v. United States, 230 F.2d 766 (1956). The taxpayer, Winkler, had been convicted of failure to file an income tax return; at the time, the relevant statute required every individual having "a gross income of $600 or more" to file a return. The taxpayer was a bookmaker who clearly had received more than $600 in successful wagers during the taxable year. On appeal, the issue was whether these receipts constituted gross income, as the trial court had charged the jury. The taxpayer contended his gambling losses, though illegal, should have been subtracted from his winning wages in computing gross income.

The court of appeals agreed with the taxpayer's position and reversed the conviction. Noting that "the justification for excluding returns of capital from gross income . . . rests ultimately upon constitutional concepts," the court held that at a minimum, "Congress is without power to deny the professional gambler the right to offset his winnings on each race with his losses in that same race before coming to a 'gain' of the type which constitutes gross income." Id. at 776.

To be sure, the cases are not unanimous in holding that a taxpayer is constitutionally entitled to subtract unlawful payments in arriving at gross income. In Pedone v. United States, 151 F. Supp. 288 (1957), a divided Court of Claims held that the taxpayers could not subtract the wages they paid employees in excess of the ceilings established pursuant to the Defense Production Act of 1950. That Act authorized the government to disregard such unlawful payments in computing taxable income. The court held that the Sixteenth Amendment is sufficiently flexible to permit the government to disallow, as a subtractable cost of goods, payments in violation of law or public policy. Id. at 291-92.

By way of analogy, the court noted the long-standing principle that subtractions for salaries and wages, particularly executive salaries, may be disallowed to the extent they are unreasonably large. This analogy strikes us as weak. Excessive salaries, especially executive compensation, may well be sales or administrative costs, or even a disguised distribution of profits, rather than a true costs of goods. The dissenting judges in Pedone argued that the unlawful payments, because they reflected the true cost of goods sold, could not constitutionally be disregarded in computing the taxpayers' income. See also Weather-Seal Mfg. Co. v. Commissioner, 16 T.C. 1312 (1951), aff'd per curiam, 199 F.2d 376 (6th Cir. 1952) (suggesting that labor costs are different from other elements of the cost of goods sold).

There is, in sum, some disagreement in the cases as to whether Congress can constitutionally preclude subtraction of unlawful payments which constitute part of the taxpayer's cost of goods sold. But this conflict, it seems to us, has arisen because of the nature of the payments at issue in the cases. The decisions authorizing the Commissioner to disregard unlawful payments, for example, have suggested that labor costs are somehow distinguishable from payments to non-employees which factor into the cost of goods. More to the point, the cases all have struggled with the somewhat distasteful proposition that the Constitution mandates sympathetic tax treatment for those who violate our laws and public policies. Quite obviously, a constitutional challenge to legislation disallowing a subtraction for a wholly legitimate component of the cost of goods would stand on firmer ground than the challenges in any of the cited cases. A fortiori, denial of deductibility or excludability of a capital cost which federal law compels the taxpayer to incur would stand on still shakier ground.

The Senate Finance Committee staff's proposal appears to fall in this last category. Federal law dictates that excise taxes and tariffs be paid; the taxpayer thus furthers rather than frustrates the law and public policy when it incurs such costs. Federal excise taxes and tariffs are seemingly genuine costs of goods, rather than mere business expenses deductible only as a matter of legislative grace. The Service has recognized that excise taxes constitute a part of the cost of goods sold, see, e.g., Rev. Rul. 85-30. The propriety of this treatment becomes apparent in light of the manner in which federal excise taxes and tariffs are imposed; for example, the excise tax affecting cigarettes is on a per-pack basis, and the tax affecting distilled spirits is imposed per proof gallon. These payments thus belong "in the 'above the line' realm of cost of goods sold," rather than "in the netherworld of deductions." See Max Sobel Wholesale Liquors v. Commissioner, 630 F.2d 670, 672 (9th Cir. 1980).

In conclusion, we believe that legislation prohibiting taxpayers from excluding or deducting federal excise taxes and tariffs for income tax purposes would be subject to a substantial constitutional attack. Such taxes and tariffs represent an important component of the taxpayer's cost of goods sold, and like other such costs are reflected in the goods' sale price and thus in the taxpayer's gross receipts. Precluding the taxpayer from subtracting a legitimate, indeed legislatively required, cost of goods in calculating gross income could well be viewed as the imposition of an unapportioned, direct tax on capital rather than the kind of income tax authorized by the Sixteenth Amendment.

Philip B. Kurland
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PBK/mm

Written Statement

of

MICHAEL J. KERRIGAN
PRESIDENT
SMOKELESS TOBACCO COUNCIL, INC.

Regarding

THE EXCISE TAX PROVISIONS IN THE PROPOSED TAX REFORM LEGISLATION

Submitted to

COMMITTEE ON FINANCE

UNITED STATES SENATE

May 5, 1986

STATEMENT OF THE SMOKELESS TOBACCO COUNCIL BEFORE THE SENATE COMMITTEE ON FINANCE

The Smokeless Tobacco Council (STC) represents the interests of 99% of the smokeless tobacco industry. Collectively, our members produce almost 127 million pounds of product per year. We also represent the interests of the 9 million American consumers of smokeless tobacco products in opposing any tax increases that would inevitably result in higher consumer prices. We appreciate the opportunity to contribute to the hearing record of this committee regarding the excise tax proposals prepared by the Finance Committee staff (Staff Option).

STC has a uniquely strong interest in the issue of excise tax deductibility. Within the past month, a new excise tax has been created and imposed on smokeless tobacco products.1/ According to the Joint Committee on Taxation, the excise tax on smokeless tobacco is designed to raise approximately $80 million dollars in new revenues over the next five years.2/ Under present law, this amount is fully deductible as a business expense. Should the Staff Option eliminating the deductibility of excise taxes be adopted, real excise tax costs would increase by approximately $37 million for the smokeless tobacco industry.

STC also strongly opposes the Staff Option proposal to raise the excise taxes on tobacco products by adjusting the rate of such taxes to reflect increases in price. As noted above, a new excise tax on smokeless tobacco products was enacted by Congress and signed into law on April 7, 1986; it will not go into effect until July 1, 1986. As a result of the imposition of this new tax (and apart from any inflation-induced cost increases), prices are expected to rise. Thus, adoption of the Staff Option would cause a certain and immediate increase in excise tax rates on smokeless tobacco, resulting in rates significantly in excess of those which Congress has just recently chosen to impose.

1/ The Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, § 13202 (1986) (to be codified at 26 U.S.C. § 5701(e)). Smokeless tobacco products (e.g., chewing tobacco and snuff) have not been subject to Federal excise tax since 1965. A previous excise tax on such products, imposed at a rate of 10 cents per pound, was repealed by the Excise Tax Reduction of 1965 (P.L. 89-44).

2/ Joint Committee on Taxation, Description of Revenue Provisions of the Consolidated Omnibus Budget Reconciliation Act of 1985 (JCS-9-86), April 25, 1986.

The views expressed below are consistent with the interests of our membership; however, it is also in the broader economic interest of the American public to reject the effective excise tax increases which have been proposed by the Chairman and his staff. Accordingly, we urge the Committee to reject the excise tax provisions for the following reasons.

I. Tax Policy and Constitutionality

First, the proposed denial of deductibility represents an unjustified departure from longstanding U.S. tax policy. Excise taxes constitute a legitimate business cost, and as such, should continue to be deducted from gross receipts to calculate taxable income. Because the proposal would result in a tax that is not "on income", it also appears to exceed Constitutional limitations.

II. Fairness and Congressional Intent

Second, the proposed adjustment of tax rates to reflect increases in price is unwarranted and contrary to the sense of Congress, particularly as applied to smokeless tobacco products. Such products are the subject of a recently enacted excise tax which will undoubtedly trigger significant price increases. A tax-induced price increase should not be the occasion for a further tax increase.

III. Impact on the Industry

Third, the new excise tax on smokeless tobacco, in combination with the denial of deductibility and the proposed ad valorem rate adjustments, will result in sharply increased tax costs on the smokeless tobacco industry. The denial of deductibility alone will increase the real cost of excise taxes by 54 percent. Smokeless tobacco companies already pay more than their fair share of taxes (an average of 40%). If producers are unable to fully pass through these costs to the consumer, profitability will be reduced and ultimately, fewer American workers will be employed.

IV. Cost to the Consumer

If the smokeless tobacco industry is forced to pass through the cost of the tax, American consumers will be hit with a regressive tax. Passed-through excise tax increases will undermine the promised benefits of tax reform for the poor and lower-middle class. It makes no sense to finance rate reduction by imposing new additional taxes on those who can least afford it.

A. The Staff Option Departs From Sound Tax Policy

Under current law, excise taxes are deductible when incurred as "an ordinary and necessary expense" of doing business or producing income. Treas. Reg. §1.164-2(f). The deductibility of excise taxes is not a loophole; rather it derives from the fundamental principle of U.S. taxation that businesses should be taxed only on their net profits, not on their gross receipts or gross income. The rationale for the deduction of business expenses is that a firm's gross receipts provides no real measure of its actual earnings.

Manufacturers' excise taxes, such as the new tax imposed on smokeless tobacco products (P.L. 99-272), constitute unavoidable costs of manufacturing or producing a given product. The manufacturer is liable for payment of excise taxes, whether or not such costs are ultimately passed on to the consumer in the form of a price increase. If the manufacturer is forced to raise prices to cover the cost of the tax, the incremental price increase must be taken into income and the manufacturer will be subject to tax on the amount. Thus, the deduction for excise taxes paid cannot be used to artifically lower taxable income; nor does it derive from a discretionary expenditure, as in the case of other common business deductions, such as entertainment expenses or advertising.

Various tax reform plans considered by the Administration and this Congress would eliminate or restrict a limited number of deductions -- chiefly those which tend to give rise to abuse by taxpayers. However, there appears to be no support in Congress or elsewhere for the wholesale elimination of deductions for legitimate business expenses. Rather, the proposal to deny the deduction for excise taxes paid is a selective measure, the single purpose of which is to raise revenue.

Excise taxes and tariffs are business costs which are borne by a discrete segment of the economy. Especially in the case of excise taxes, there is an identifiable group of enterprises -- primarily those engaged in the manufacture, production or sale of taxable goods and services -- that will be hardest hit. Thus, the Staff Option is both objectionable in principle and discriminatory in effect.

In addition to departing from the fundamental "net income" concept of business taxation, the proposal appears to create a tax that is not based on "income" at all. For the business taxpayer, tariffs and most excise taxes constitute expenditures directly connected with the production or acquisition of goods held for sale. As such, excise tax or tariff payments are classified as capital costs and included in the taxpayer's "cost of goods sold" (along with the cost of raw materials and other direct costs). Cost of goods sold must be subtracted from gross receipts to arrive at gross income. Thus, a tax on tariff or excise tax costs deviates from a tax on "income" and, according to our attorneys, raises serious Constitutional objections.[3]

B. The Staff Option Imposes an Unfair Increase in Excise Tax Rates

A second excise tax provision, which would adjust alcohol, tobacco and fuel excise tax rates to reflect increases in price, would result in substantial "backdoor" increases in excise tax rates. Although the details of the this provision have not yet been worked out, it would appear to increase tax rates on these products whenever consumer prices rise, and regardless of whether such price increases reflect increased profits or merely increased costs.

A simple example will illustrate. Assume, as is the case under current law, that a manufacturer is liable to pay an excise tax at a given rate per volume of the taxable product -- e.g., 24 cents per pound (the recently enacted rate applicable to snuff). Assume further that, as a result of inflation-induced wage hikes, the manufacturer's costs of production increase. The manufacturer will naturally attempt to cover those costs by raising the price of the product. Under current law, the price change will not incur an increase in taxes. However, under the proposal, any increase in the sales price (whether imposed by the manufacturer or some other party in the chain of distribution) will trigger a corresponding increase in the effective per-volume rate of tax.

The proposed shift to ad valorem taxation would be particularly unfair and burdensome for the smokeless tobacco industry. Congress has just enacted legislation imposing an excise tax on smokeless tobacco products manufactured in or imported into the United States. The new tax, which will go into effect on July 1, 1986, places a levy of 24 cents per pound on snuff and 8 cents per pound on chewing tobacco. After carefully considering the economic consequences to the industry in light of the Government's need for revenue, Congress decided that these rates were reasonable and fair. But if excise tax rates are "indexed" to reflect future price increases, this considered decision will be automatically and abruptly discarded.

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[3] We understand that this point was made by several witnesses whose testimony was delivered to the Committee on the day of the hearing (April 21, 1986). See, e.g., the testimony and exhibits submitted on behalf of the Coalition Against Regressive Taxation. Therefore, we need not elaborate on it here.

It is reasonable to assume that as a result of the new tax on smokeless tobacco, the prices of such products will increase in the near future. Under the indexing provision, any increases in the price of taxable products will trigger corresponding increases in excise tax rates for that product. Thus the shift to *ad valorem* taxation, in the case of the smokeless tobacco industry, is virtually certain to result in an increase in rates in excess of those imposed on the industry by this Congress.

In the case of products which have been continuously subject to excise taxes, the proposed denial of deductibility will occasion similar *spiraling* increases: Any attempt by producers to pass along effective increases in real tax costs will trigger further tax increases. Thus if the indexing proposal is adopted, the overall increase in excise tax costs could far exceed the 54% increase attributable to the loss of deductibility.

C. The Staff Option Will Have Adverse Economic Effects on the Smokeless Tobacco Industry

The smokeless tobacco industry already pays its fair share in taxes. Unlike some corporations which pay little or no income taxes, smokeless tobacco companies pay an average of 40 percent of their income in federal taxes. Among manufacturers, this represents an extremely high rate of tax.

The new excise taxes imposed on smokeless tobacco products, combined with the proposed repeal of deductibility, will result in a substantial increase in real tax costs (calculated as a percentage of the industry's gross revenues). The annual gross revenues of the smokeless tobacco industry total approximately $1 billion. According to a recent report prepared by the staff of the Joint Committee on Taxation, the new taxes on snuff and chewing tobacco are expected to yield a total of $15 million in annual tax revenues.4/ Assuming loss of deductibility, the smokeless tobacco industry will bear this cost in full. This amount represents a full 1.5% of the industry's gross revenues. If the smokeless tobacco industry is forced to absorb this amount, companies will face a sharp drop in profitability which, in the long run, will severely damage productivity and hamper future growth.

4/ Joint Committee on Taxation, Description of Revenue Provisions of the Consolidated Omnibus Budget Reconciliation Act of 1985 (JCS-9-86), April 25, 1986. The $15 million estimate is for 1987, the first full year the new excise taxes will be in effect.

Naturally, the smokeless tobacco industry will seek to pass through its increased tax costs, at least in part, to the consumer. However, it cannot assume that all increased costs can be passed through. First, our industry has no recent experience with excise taxes, and thus cannot confidently predict, at this point, what portion of the new excise taxes will be borne by the consumer. Second, the demand for tobacco products is not completely inelastic.5/ Consumers tend to respond to price increases by reducing consumption. Thus, if producers attempt a full pass-through of increased tax costs, the net result may still be decreased profitability due to lowered volume of sales.

In the final analysis, any decrease in the overall volume of smokeless tobacco sales translates into loss of American jobs. In addition, as sales drop, our purchases of American tobacco leaf will inevitably decline. Our industry directly employs thousands of American workers and provides income for thousands of small American tobacco farmers, our principal suppliers. Smokeless tobacco manufacturers prefer to use domestic product and only seek supplies overseas when domestic production does not meet their demand. In the last year for which figures are available, more than 95% of our tobacco was produced by American farmers.

In recent years, both farming and domestic manufacturing have experienced dramatic declines in the number of full-time employees. Adoption of the excise proposals contained in the Staff Option will exacerbate this unfortunate trend.

D. The Staff Option Will Increase the Tax Burden on Consumers and Vitiate Tax Reform for the Poor

The proposed excise tax increases, taken collectively, will have a major impact on consumer prices. As noted above, it is uncertain, in the case of smokeless tobacco products, whether the additional tax burdens on producers will be passed through in full to individual consumers. However, we do know that to the extent such costs are passed through, the cumulative effect will be to "undo" tax reform for the majority of lower-income Americans.

According to a study by deSeve Economic Associates, the excise tax and tariff increases in the plan before the Senate

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5/ Although we know of no studies documenting elasticity for smokeless tobacco products, researchers estimate the price elasticity of demand for cigarettes may be as much as -.5. Thus a 20 percent increase in price results in a 10 percent drop in sales. The 1983 excise tax increase on cigarettes reportedly caused a market decline of 6 percent.

Finance Committee would be borne disproportionately by low income taxpayers. For example, households with incomes of less than $10,000 would pay 8 percent of the excise and tariff increases, even though they earn as a class only 3 percent of all income. Likewise, households with incomes of less than $20,000 would pay 23 percent of the increases but account for only 12 percent of all income.[6] The study concludes that the excise tax increases would effectively wipe out well over half of the income tax reductions promised to taxpayers in the lower-income classes by the Chairman's plan.

Excise tax increases on smokeless tobacco are particularly regressive because smokeless tobacco users are generally poorer than the average consumer. Quantitative studies commissioned by our industry in 1984 show that 25 percent of smokeless tobacco users have annual incomes of less than $15,000; and fully one-half of all users have annual household incomes of less than $25,000. These consumers will be especially hard hit by the regressive nature of the proposed excise tax increases. Regressivity runs counter to a basic principle in our tax code -- that the poor should not bear a greater tax burden than the rich.

Conclusion

In summary, the proposals to eliminate the deductibility of excise taxes and to increase excise rates to reflect increases in price would unfairly burden both domestic industry and the American consumer. The elimination of deductibility represents a major departure from longstanding U.S. tax policy. In its present form, the proposal also appears to exceed Constitutional limitations. Even if deductibility is retained, the proposed excise tax increases will selectively burden particular industries and segments of the American economy. The excise tax provisions in the Chairman's plan, taken together with the recently enacted excise tax on smokeless tobacco, will dramatically increase taxes for smokeless tobacco companies. These companies are already paying a large percentage of their earnings in taxes.

If additional revenue is needed to finance rate reduction, surely some way can be found to equalize the tax burden among all industries. The mandate of tax reform is to create a level playing field for all types of productive, economic activity. The excise tax proposals would have the opposite effect. If such proposals are adopted, a few industries would be singled out for confiscatory and punitive tax increases, while others would continue to pay far less than their fair share.

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[6] By contrast, households with incomes above $100,000 -- which account for 14 percent of all income -- would pay only 6 percent of the tax increases.

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STROH

THE STROH BREWERY COMPANY
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DETROIT, MICHIGAN 48207

PETER W. STROH
CHAIRMAN AND CHIEF EXECUTIVE OFFICER

April 18, 1986

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
Washington, DC 20310

Dear Mr. Chairman:

Thank you for providing us the opportunity to comment on the tax reform proposals prepared in connection with the Committee on Finance Markup. The Stroh Brewery Company joins the other members of our industry in objecting in the strongest possible manner to those proposals that would end the deductibility of the Federal Excise Tax (FET) on malt beverages, provide for the adjustment of the FET to reflect changes in prices and increase the FET rate on wine to the so-called "proof rate" imposed on beer.

We will not repeat the excellent arguments presented on behalf of the beer industry by August Busch which we wholeheartedly endorse. We will use this opportunity to set out the particularly damaging effect the proposals would have on The Stroh Brewery Company and other FET payers similarly situated.

Stroh is the nation's third largest brewer and is the largest family-owned and operated brewer in the country. We produce 14 brands and 7 light extensions in six breweries strategically located around the United States. In addition, we are actively engaged in the manufacture of containers and in a growing container recovery and recycling program.

A large percentage of the approximately 23 million barrels we sell annually is priced in the "popular" category. These high-quality products are offered at a price lower to the wholesaler and to the consumer than those products in the "premium" category. As a result, the FET represents a much greater percentage of the overall selling price of our popular priced products. Therefore, the proposal for a back-door increase in the FET by way of eliminating the FET deduction would have the effect of doubling what is already a relatively higher tax percentage paid by our customers.

If the FET were not deductible, Stroh would be faced with a choice. First, Stroh could choose to drastically raise prices in an amount effectively equal to the amount of this tax increase. These price increases would be particularly onerous for lower income consumers who purchase our lower priced beers. The potential impacts of such increases on Stroh and on the industry in general are well documented in Mr. Busch's testimony. Alternatively, the brewery would suffer such devastating operating losses that it would be forced to end the more than 150 years of brewing by The Stroh Brewery Company.

It is difficult to comment on the proposal to index alcoholic beverage federal excise taxes to price increases because we have been unable to obtain any clarification whatsoever from the Finance Committee staff on how this proposal would operate. Therefore, we join in opposing it on the reliable assumption that it could only serve to raise taxes and prices.

Finally, we must also register our objection to the proposed increase in wine tax rates to a rate equivalent to beer. While not directly affected by this increase, Stroh joins the beer industry in opposing this proposal. We particularly object to this proposal because it is based on the fallacious notion that all alcoholic beverages are the same.

In summary, we reiterate our strong objection to the proposals calling for the non-deductibility of excise taxes, the indexing of FET to price, and the equilization of wine taxes to beer, and we urge the rejection of the proposals. The Stroh Brewery Company appreciates the opportunity to present our views, and, as always, should you have any comments or questions, please do not hesitate to contact us.

Sincerely,

Peter W. Stroh

PWS:ll

T

THE TOBACCO INSTITUTE
1875 I STREET, NORTHWEST
WASHINGTON, DC 20006
202 457-4830

HORACE R. KORNEGAY
Chairman

April 29, 1986

The Honorable
Bob Packwood
257 Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

The hearing conducted by the Senate Finance Committee on April 21 relating to excise tax and tariff proposals generated some apparent confusion about certain matters of fact. In the belief that clarification may be helpful to you and other members of the Committee, we are writing to set the record straight on a few matters that may be of some importance as the Committee makes its decisions. Although your hearings tended to focus on specific proposals such as eliminating the income tax deduction for payment of excise taxes, we believe that the following points are pertinent to consideration of any proposal that would raise excise taxes.

1. Tax burden on tobacco.

Various figures were given to the Committee ostensibly reflecting the tax burden borne by the tobacco industry, ranging from 29 percent to 50 percent of the retail price of a pack of cigarettes. Most witnesses hostile to smoking are in the habit of discussing tobacco's tax burden in terms that suggest that the only tax it bears is the Federal excise tax. State and local taxes account for even more. The total excise tax burden (Federal, State and local) on cigarettes amounts to 31 percent of the purchase price.

Futhermore, as a study conducted by Chase Econometrics completed in May 1985 concluded, the income, excise, sales and FICA taxes paid by the industry in 1983 amounted to 47.6 percent of total U.S. consumer expenditures on tobacco products. State and local taxes have gone up since then. This figure does not take into account many other taxes, including property taxes, taxes on inventories, business license taxes and miscellaneous others imposed by many jurisdictions. It is, however, a more valid measure of the tax burden imposed on this industry than the excise tax alone.

2. Tax burden over time.

Likewise the Committee may have been left with a mistaken impression by testimony alleging that the tax burden is lower today than it was in 1951. It is strange indeed to contemplate that a tax rate below that imposed 35 years ago to finance the war in Korea is somehow undesirable. But, in the interest of factual accuracy, it should be noted that state and local excise taxes on tobacco have gone up by 520 percent in the past 35 years, far in excess of the rate of inflation. The Federal excise tax has doubled since 1951. The combined excise tax burden on tobacco has not lagged far behind the rate of increase in the CPI.

3. Regressivity.

Surely the regressive impact of a tax cannot be ignored simply because not everyone pays it, as some witnesses seemed to suggest. It is false to suggest that distributional effects of a tax cannot be measured among income groups when not everybody is affected by the tax. A significant part of the public does not pay an income tax; yet, the Finance Committee has before it an analysis of the distributional effects of proposed income tax reductions.

Approximately 18 percent of federal income tax revenues comes from persons with incomes below $20,000. Approximately 39 percent of tobacco excise tax revenues comes from that same income class. No one can doubt that the cigarette excise tax is one of the most regressive of Federal taxes.

4. Excise tax/income tax interaction.

The Government collects the cigarette excise tax in full. The companies paying it withhold nothing; in fact, they incur a cost in the process because they must make payment before they are reimbursed from wholesalers/distributors.

It is true that excise taxes, like almost all other forms of business taxation, are deducted from gross income before determining the tax due on net income. And it is certainly a truism that the income tax liability, after taking deductions for taxes, is less on any given amount of gross income than it would be if taxes were not deducted.

However, to the extent that the excise tax is passed along to the consumer (as is the case with the tobacco industry), the entire excise tax (not 78 percent as suggested by the Joint Committee on Taxation) is realized by the Government even after the income tax deduction. The excise tax that is passed along and the deduction for the tax are the same amount; therefore, the net income after the deduction is the same as it would be without any excise tax, resulting in a net zero income tax loss because of the deduction.

5. "Social Costs"

In his testimony Assistant Secretary Mentz stated that, "One of the traditional justifications for imposing an excise tax is to ensure that the market price of a good reflects any external social costs associated with its production or consumption." Absolutely no precedent was cited to support this startling assertion. Although various social engineers might have it otherwise, no major federal excise tax has ever been imposed to recover so-called "social costs."

We shall be happy to furnish any further information you and your colleagues would find helpful.

Sincerely,

Horace R. Kornegay

HRK/sr

cc: Senate Finance Committee Members

STATEMENT ON PACKWOOD EXCISE TAX
PROPOSALS

Robert D. Tollison

Center for Study of Public Choice
George Mason University
Fairfax, Virginia 22030

I have been asked today to testify about Senator Robert Packwood's recent tax reform proposal. The features of the plan I wish to focus on are its provisions concerning changes in the law affecting Federal excise taxes.

The plan has three major excise-related parts: the disallowance of the deductibility of Federal excise tax payments by firms and individuals from their Federal income tax liability; an "anti-avoidance rule" forcing all taxpayers to pay income tax on the amount of their Federal excise tax liability, regardless of other deductions which may apply; and a continuing upwards adjustment of excise taxes to ensure that they rise with inflation.

This plan is little more than a thinly disguised call for a major increase in the excise tax burden of American consumers. This tax increase is not only Senator Packwood's obvious goal, but is a goal which J. Roger Mentz of the Department of the Treasury has defended on the grounds of being economically efficient. All of his arguments are badly flawed. As these claims are often dragged out by the proponents of excise tax increases, they deserve a close scrutiny.

1. Mentz asserts that an increase in selective excise taxes like the Packwood Plan would produce can be justified by the need for government tax policy to reduce the external "social costs" associated with taxed activities. This "social cost" argument is economic nonsense. Market prices reflect the full economic costs of goods and services to the extent that these are measurable. The price system is very efficient at taking all costs into account. It is entirely arbitrary to claim that there are some other, additional costs which can't be measured. It is

ridiculous to base tax policy on unmeasurable ghosts. When someone claims that some individual's activity generates "social costs" what they are really saying is that they personally don't like that activity but are unwilling to pay that individual to stop doing it.

2. Mentz defends the Packwood excise tax increase by claiming that excise taxes are "surrogate user fees". User fees can provide for the efficient allocation of resources controlled by the government; for example, it may be more efficient for the users of parks to pay for them out of admission fees than to have non-users pay for them out of taxes. In other words, the recipient of a service pays what the service is worth to him. But nobody who pays excise taxes receives any service in "exchange": excise taxes are not a "fee" for anything. Excise taxes cannot be described as user fees, which Mentz obviously realizes or he would'nt use an evasion like the word "surrogate". This is a snow job pure and simple. It is nothing more than a technical-sounding excuse for higher taxes.

3. According to Mentz, it does'nt matter if excise taxes are increased because these taxes are levied on "inelastically demanded goods" and consumer behavior will be little affected by price increases. What he ignores is the fact that both the producers and consumers of such goods will also tend to invest greater resources in fighting tax increases, instead of simply shifting to the production or consumption of different goods. These efforts represent pure waste from the standpoint of society. The bottom line is that the efficiency losses associated with increasing taxes on inelastically demanded goods may

actually be greater than in cases where the elasticity of demand is greater.

4. Excise taxes are highly regressive: they impose a disproportionate burden on the poor. The Packwood excise tax increase would harm the poor very significantly. Mentz admits the regressivity of excise taxes, but employs pseudo-economic double-talk to deny that this fact is important. He says that because families tend to earn higher incomes as they grow older, their relative excise tax burden decreases with time. This is irrelevant, and callous to boot: poor families will bear a high burden resulting from excise tax increases in the here-and-now, regardless of what their income might be in thirty years. He then proceeds to make an even sillier argument, that because individuals who don't consume any of the taxed goods obviously bear no burden from the tax, this somehow puts the "distributional consequences" of the tax in a "new light". This "new light" he refers to is a frankly elitest light. So what if poor people suffer as a result of the burden imposed by increased excise taxes; they consume more of the taxed goods than Mentz thinks they should, anyway.

5. The Packwood Plan would increase excise taxes which Congress has set at a per unit basis (X dollars per pound/gallon) automatically to supposedly keep pace with inflation. This reverse indexing scheme is just the opposite of the indexation of the income tax, which was designed to protect taxpayers from automatic tax increases. Reverse indexing of Federal excise taxes would merely protect Congress from responsibility for determining tax rates. It would serve to make a significant portion

of Federal tax policy uncontrollable. Even worse, the Packwood Plan specifically requires that excise tax rates cannot be allowed to fall below levels in current law; in other words, if the consumer price level fell (a distinct possiblity in the near future) the tax rates in constant dollars would automatically increase.

In conclusion, the Packwood Plan for changes in the Federal tax law concerning excise taxes would constitute a massive, highly regressive increase in the tax burden of American consumers. No amount of hand-waving with misleading economic jargon will change this fact.

T

The resolutions are similar to AMA 1985 positions on tobacco advertising (now in the U.S. Senate), and their support of an increase in the cigarette tax to 32¢ per pack, up from the present 16¢.

An outright abolition of alcohol "ads" would be fought by the media becuase of advertising revenues. The tax approach would generate revenues of over one billion dollars, This would help supplement government income and thereby lessen the pressure to decrease federal health appropriations, or increase other taxes elsewheres. Also, by making alcohol advertising more expensive, there might be fewer "ads", thus discouraging some drinking, especially among some teenagers who are misled into prematurely starting to drink for the wrong reasons.

Increases for federal excise taxes for beer and wine are being considered by Senator Packwood's Senate Finance Committee Hearing April 21 [CAP please] as part of Tax Reform Package, or separate tax proposal to head off the military and domestic cutbacks mandated by the Gramm-Rudman deadline. Like tobacco, increased costs might discourage some consumption, and would certainly help pay for some of the costly consequences of drinking.

Alcohol excise taxes are an important preventive medical measure in combating alcohol abuse. The price of alcohol to society (including medical costs, time lost from employment, property damage, etc.) amounted to over $100 billion dollars ā year (1981 estimate). The medical profession and Congress would do well by supporting these beer and wine tax increases.

The present tax on 1 ounce of liquor is 9¢ (a 2¢ increase since 1984), 12 ounce can of beer tax is 2 1/2¢ and 4 ounce of wine is 1/2¢. Tripling the beer tax to 7 1/2¢ per can and increasing the tax on wine 10 times to 5¢ per 4 ounces would be a way of equalizing taxes on different alcoholic beverages since the tax on liquor is high enough.

The 1984 revenues from these excise taxes were $5.4 billion for distilled spirits, $300 million for wine, $1.5 billion for beer and

$4.7 billion for tobacco. These figures illustrate how significant tax revenues could be if excises were increased. Six billion dollars additional revenue would accrue if the tax on beer increased three times and wine ten times.

After the beer and wine tax hike, it is proposed that all future alcohol and tabacco excise TAXES BE ADJUSTED ANNUALLY for inflation, to prevent a repeat of the past 35 years when the alcohol beverage industry hadn't paid any increase in excise taxes and while inflation and government services have more than tripled. COLA here would yield $500 mil per year.

In summary, these tax changes in federal excise and advertising would produce revenues in the billions and lessen the pressure to increase taxes in other areas. This money would be utilized to help pay for our defense, pensions, domestic health programs and/or to head off budget cuts because of the need to further lessen our annual deficit.

(A)

References for inclusion

(A)

AMA Insights

- FROM Jn of (Journal) AMA April 4, 1986

MEMBERS OF BOTH THE HOUSE AND SENATE have introduced legislation that would ban tax deductions for the expenses of advertising tobacco products. The legislation, supported by the AMA and other medical groups, could eliminate incentives that encourage tobacco companies to promote their products. Some estimates show the proposed law could result in $2.3 billion in additional federal revenues during the next three years, legislators noted. . . .

(B)

2-25-~~85~~ (DER) TAXATION ~~AND~~ ACCOUNTING (No. ~~37~~) G - 3

(B) + Internal Revenue Report of Excise Taxes
Summary for Quarter ended September and Fiscal Year 1984
(In Thousands of dollars)

Source of revenue	Quarter Ended September		Fiscal Year	
	1983	1984	1983	1984
Total excise taxes	10,087,283	9,821,785	35,765,538	38,017,486
Alcohol taxes, total¹	1,646,688	1,441,480	5,634,853	5,402,467
Distilled spirits	1,045,906	867,837	3,798,148	3,566,482
Wines	45,933	107,108	239,329	319,920
Beer	556,050	466,535	1,597,375	1,516,064
Tobacco taxes, total¹	1,361,508	1,233,254	4,139,810	4,563,610
Cigars	11,181	8,069	33,716	30,372
Cigarettes¹	1,348,293	1,222,152	4,099,226	4,523,288
Other¹	2,034	3,033	6,867	9,950

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0148-8155/85/$00.50

From 2/25/85 Report

(C)

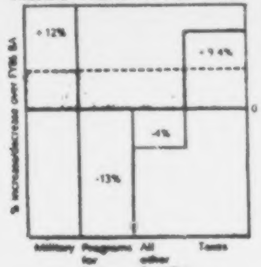
LIFE AFTER GRAMM-RUDMAN-HOLLINGS

(C) (From FCNL Washington Newsletter, March 1986)

Page 4

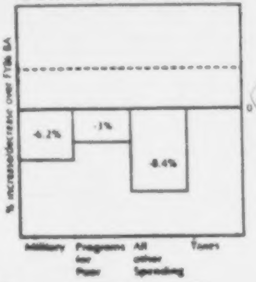
The Gramm-Rudman-Hollings law (P.L. 99-177) mandates reductions in the deficit. It does not require, however, that these reductions be made in any particular way unless Congress and the president fail to act. Only then do the automatic formulas come into play. An imaginative and courageous Congress could find ways to further a positive social agenda and to make progress toward international understanding, while adhering to the Gramm-Rudman spending limitations. These are some of the options.

PRESIDENT REAGAN'S PROPOSAL



▭ inflation expected for FY87 4.1%

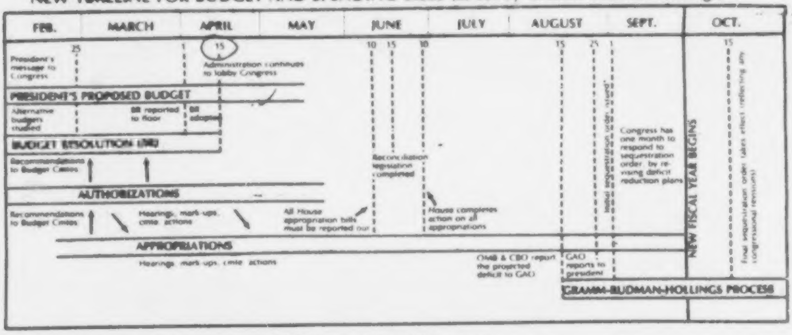
G-R-H AUTOMATIC FORMULA¹



¹Figures based on CBO projections for 1987

BEST SOLUTION
Started by Sen Dominici
and Senate Finance Cmm.
$18 Billion in new taxes
(* Excise taxes? enough?)
Needs MD backing
Less domestic & health cuts
Military Freeze
6% More than with
GRAMM-RUDMAN
Package will be passed
by House Senate Conf in July
and accepted by PRES REAGAN
(J Tyson MD
addendum
Albq NM)

NEW TIMELINE FOR BUDGET AND SPENDING BILLS (as set by Gramm-Rudman-Hollings)


FEB.
MARCH
APRIL
MAY
JUNE
JULY
AUGUST
SEPT.
OCT.
25
1
15
10
15
10
15
25
1
15
President's message to Congress
Administration continues to lobby Congress
PRESIDENT'S PROPOSED BUDGET
Alternative budgets studied
BR reported to floor
BR adopted
BUDGET RESOLUTION (BR)
Recommendations to Budget Cmtes
AUTHORIZATIONS
Recommendations to Budget Cmtes
Hearings, mark-ups, cmte. actions
All House appropriation bills must be reported out
Reconciliation legislation completed
House completes action on all appropriations
APPROPRIATIONS
Hearings, mark-ups, cmte. actions
OMB & CBO report the projected deficit to GAO
GAO reports to president
Initial sequestration order issued*
Congress has one month to respond to sequestration order by revising deficit reduction plans
NEW FISCAL YEAR BEGINS
Final sequestration order takes effect (reflecting any congressional revisions)
GRAMM-RUDMAN-HOLLINGS PROCESS

*Sequestration orders issued only if Congress and president fail to agree on required deficit reductions

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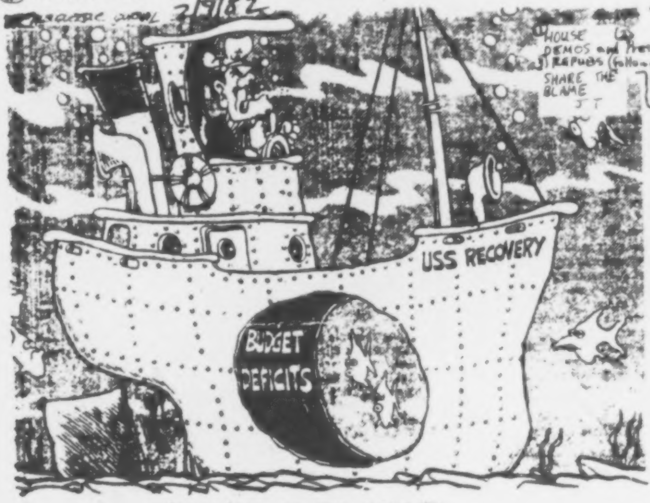
(D) Cartoon FROM ALBQ (NM) JOURNAL by Trevor 2/9/82

Dr Tyson adds 4/86


USS RECOVERY
BUDGET DEFICITS

(1) HOUSE DEMOS and President (vetoing Soc Sec. COLA check)
(2) REPUBS (following Kemp ↓ taxes; Weinberger ↑↑ military)
SHARE THE BLAME
JT

"STEADY AS SHE GOES!!"

NOW CONGRESS MUST RAISE NECESSARY TAXES, TO PAY OUR WAY, AND PREVENT INCREASING DEFICIT and DEBT INTEREST FROM DROWNING US IN THE NEXT FEW YEARS

LETS BUST THE BUDGET DEFICIT WITH EXCISES!

By Michael Jacobson

Nutrition Action (Oct 81 page 6)

Grappling With Alcohol Abuse: When Will We Take a Stand?

Of all society's difficult problems, alcohol abuse is certainly one of the most intractable. Yet alcoholic beverages themselves are a tradition on the dinner table and are high on the list of pleasures. Alcohol also supports a large industry, providing jobs for thousands of bartenders, brewmasters, advertising executives, and liquor store employees. The downside, though, is sobering.

Excessive drinking destroys thousands of lives and families each year. Nearly everyone is touched, directly or indirectly. Alcohol can cause mental retardation when it reaches fetuses. Alcohol—especially in combination with cigarette smoking—can cause cancer of the mouth, throat, pharynx, and larynx. Alcohol can rot the brain and liver. And alcohol leads to thousands of traffic fatalities, falls, suicides, fires, and domestic disputes and deaths each year. The death toll due to alcohol is estimated to reach between 50,000 and 200,000 people a year.

The Institute of Medicine of the National Academy of Sciences has calculated that the price to society of alcohol abuse—including medical bills, time lost from work, property damage, and other costs—amounted to as much as $60 billion in 1975 (*Alcoholism, Alcohol Abuse, and Related Problems*, 1980). Adjusting only for inflation, the 1981 figure will pass the $100 billion mark.

Now, don't get me wrong. I am not advocating prohibition. I like my glass of chablis as much as the next fellow. But thousands of lives and $100 billion a year is nothing to sneeze at. It is about time that society put some real money and muscle into the fight against excessive drinking.

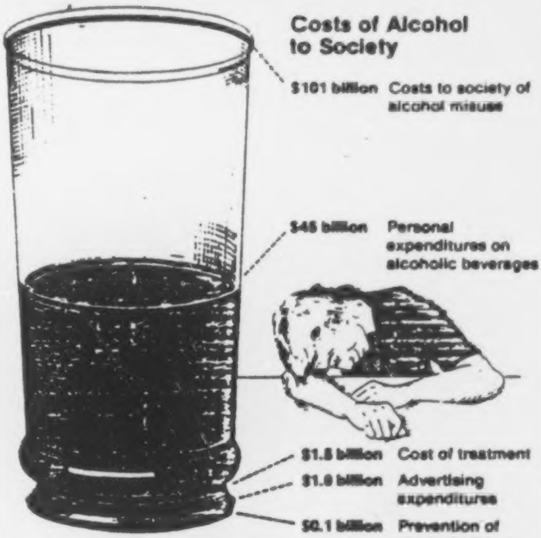
Treating and preventing alcoholism, a true addiction, is no small challenge. People drink for different reasons. Each kind of drinker must be handled appropriately. While an educational program may work with pregnant women, a good job and a decent home may be the only solution for middle-aged working people who turn to alcohol out of depression. For teen-aged drinkers, high prices may be the key to limiting availability. And for habitual drunk drivers, loss of licenses may serve as a deterrent.

New Strategies Needed

Measures that deserve careful consideration, some having proven themselves effective in one place or another, include:

- steep taxes on alcohol both to discourage drinking and finance educational campaigns, half-way houses, scientific research, and counseling programs. Many experts believe that high prices will be the only effective way of fighting alcoholism.
- warning labels in advertising and on beverage labels: Sen. Strom Thurmond (R - S.C.) recently introduced legislation, S. 1543, that would require warning notices on distilled spirits' labels.
- calorie declarations on alcoholic beverages. This would remind drinkers of the caloric prices their waistlines pay for every sip of sherry. The average serving of an alcoholic beverage provides 150 calories.
- stiff penalties for drunken driving, including mandatory revocation of driver's licenses and imprisonment for repeat offenders.
- educational efforts beginning in childhood. It may be more effective to recommend sensible drinking than total abstinence.

Research for this story by D'Anne DuBose



Costs of Alcohol to Society

$101 billion Costs to society of alcohol misuse
$45 billion Personal expenditures on alcoholic beverages
$1.5 billion Cost of treatment
$1.0 billion Advertising expenditures
$0.1 billion Prevention of alcohol misuse

Figures are [illegible] approximations based on government or industry data.

(continued)

[illegible]

It's easy to talk about such measures—in fact, every few years a blue-ribboned commission produces similar recommendations that stir little action. Americans buy about $43 billion worth of alcoholic beverages each year, and the giant industry is not about to sit back and allow a bunch of "do-gooders" to jeopardize its profits.

Ironically, a warning notice on the label may be one of the first measures to be adopted. It's not that producers like the idea, but the notice would protect them from product liability suits stemming from alcohol, such as babies with fetal alcohol syndrome or people who develop throat cancer.

Perhaps the toughest thing to achieve will be higher taxes. Though alcohol taxes have provided gradually increasing income for government, the federal tax per unit of alcohol has remained the same over thirty years. For distilled spirits the tax has been $10.50 per proof gallon (one gallon of 100-proof alcohol). Because of inflation, the actual value of the tax today is less than one-third of what it was in 1951.

Inflation Erodes Deterrent

If the alcohol tax were simply brought back to its original value, the federal government would reap about $15 billion more in revenue each year. The higher prices for beverages would also have a modest impact on drinking.

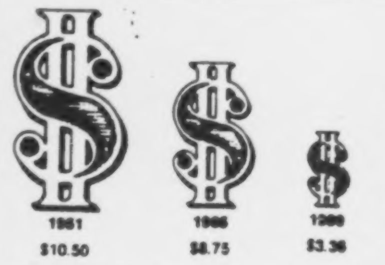
Had the federal excise tax on alcohol kept pace with inflation between 1951 and 1980, Uncle Sam would be $77 billion richer. And in the next four years another $80 billion will be lost to the Treasury unless government acts now. A higher excise tax could be embraced by an administration that has promised to balance the federal budget by 1984.

Compared to the harm inflicted upon society and the cost of the beverages themselves, funds devoted to fighting alcoholism are puny. Indeed, the industry spends about as much to promote its products—roughly $1 billion per year—as society spends to treat and rehabilitate alcoholics. Less than one-tenth of that amount is spent on prevention programs.

When it comes to lobbying, the imbalance is even more obvious. Only a few, small, citizens groups—most notably the American Council on Alcohol Problems, which has been rallying support for alcohol warning labels—have advocated tighter control over alcohol.

On the other hand, the wine, beer, and distilled spirits industries sponsor powerful lobbies and enjoy the sympathies of many legislators. Magazines and the electronic media depend heavily on alcohol ad dollars and do not advocate tough measures in their editorial columns or commentaries. Liquor wholesalers and liquor store owners provide political firepower at the grassroots level.

Instituting a comprehensive program to fight alcoholism will require cooperation between the drinkers, citizens groups, alcoholism counselors (a small army these days), educators, health professionals, sympathetic government officials, and legislators. Both local and national efforts are vital. The battle against alcoholism should be one in which all segments of our politically diverse society can participate. ●



Relative Value of Alcohol Tax Since 1951

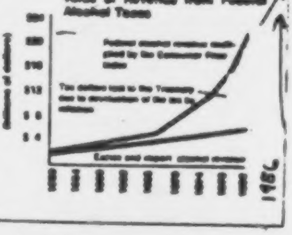
The tax per proof-gallon (one gallon of 100-proof) has remained constant at $10.50 since 1951, but its relative value has declined due to inflation.

Alcohol Taxes Inconsistent

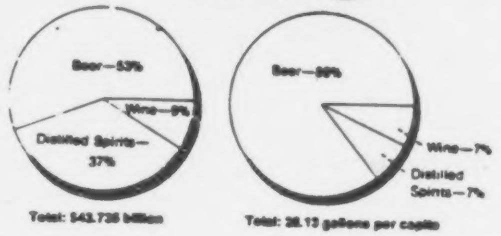
The federal tax rates on alcoholic beverages make no sense, except insofar as they reflect the relative lobbying abilities of different segments of the industry. By units of alcohol, the tax on beer is only one-fourth the tax on distilled spirits; the tax on wine is one-sixteenth the tax on spirits.

The federal tax on a bottle (25.4 ounces) of 86-proof whiskey is $1.67; the tax on a six-pack (72 ounces) of beer is $0.16; and only $0.0[illegible] on a bottle (25.4 ounces) of table wine.

Actual vs. Inflation-Corrected Value of Revenue from Federal Alcohol Taxes



Consumer Expenditures and Alcoholic Beverage Consumption 1979



Total: $43.735 billion

Total: 28.13 gallons per capita

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STATEMENT
on
EFFECTS OF THE EXCISE TAX AND TARIFF PROVISIONS
before the
SENATE FINANCE COMMITTEE
for the
U.S. CHAMBER OF COMMERCE
by
Dr. Richard Rahn*
May 5, 1986

The U.S. Chamber of Commerce welcomes the opportunity to submit testimony on the economic effects of the excise tax and tariff provisions of the Senate Finance Committee tax reform proposal.

The Chamber supports tax reform that would lower rates and broaden the base in the interest of stimulating capital formation, technological advancement, international competitiveness, and job creation. It opposes the excise tax and tariff provisions in the Senate Finance Committee tax reform proposal because of their detrimental effects on business and the U.S. economy.

The Chamber is extremely concerned that the excise tax and tariff proposals in the Finance Committee tax reform plan would: 1) reduce economic growth by increasing excise taxes by 54 percent; 2) harm large corporations and small businesses by not allowing a legitimate business deduction and requiring payment of taxes on nonexistent profits; 3) increase the price of products consumers must buy; and 4) reduce the value dramatically of any individual tax rate reductions involved in tax reform, primarily affecting lower and middle income taxpayers.

I. THE NONDEDUCTIBILITY OF EXCISE TAXES AND TARIFFS

Under the Senate Finance Committee proposal, the deductibility of all excise taxes and tariffs by business income taxpayers would be disallowed. In addition, excise taxes on alcohol, tobacco, and motor fuels would be imposed on an ad valorem basis, rather than the current ad rem basis, which means they would be increased to reflect increases in product price.

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*Vice President and Chief Economist, U.S. Chamber of Commerce

A Tax Increase, Not A Loophole

The repeal of deductibility is nothing but a back-door tax increase. At a 35 percent corporate tax rate, the proposal is equivalent of a 54 percent across-the-board increase in excise tax rates. The amount of excise taxes paid would be included in the income of a business, and then the income tax rate would be applied to that increased net income, increasing the amount of taxes paid. By denying deductibility of excise taxes, the true rate of the excise taxes would be increased, exacerbating their already distortionary effects on the economy. Nondeductibility could also increase the income tax rate paid on net income.

Present Law Example: Suppose a business bought a widget for $8.00 from its supplier and under present law it was required to pay an excise tax of $1.00. If it sold the widget for $10.00, its gross profit and taxable income would be $1.00. At a 35 percent tax rate, the firms income tax liability would be 35 cents and its after-tax profit would be 65 cents.

Senate Finance Committee Example: The business would buy the widget for $8.00 from its supplier and pay an excise tax of $1.00 per widget. If it sold the widget for $10.00, its gross profit would be $1.00, but because the excise tax paid is no longer deductible, its taxable income would be $2.00. At a 35 percent rate, the firms income tax liability would be 70 cents and its after-tax profit would be 30 cents. In order to retain an after-tax profit of 65 cents per widget, the firm would be required to sell each widget for $10.54.

At a price of $10.54, its gross profit would be $1.54, but its taxable income would be $2.54. At a 35 percent rate, the firms income tax liability would be 89 cents. Its gross profit of $1.54, less its tax of 89 cents, leaves an after-tax profit of 65 cents per widget (see Chart 1).

Chart 1

Current Law

Price of widget	$ 8.00
Excise tax	$ 1.00
Gross profit (taxable income)	$ 1.00
$1 profit-tax at 35%	$ .35
After-tax profit	$ .65
Price of Product	$10.00

SFC Proposal

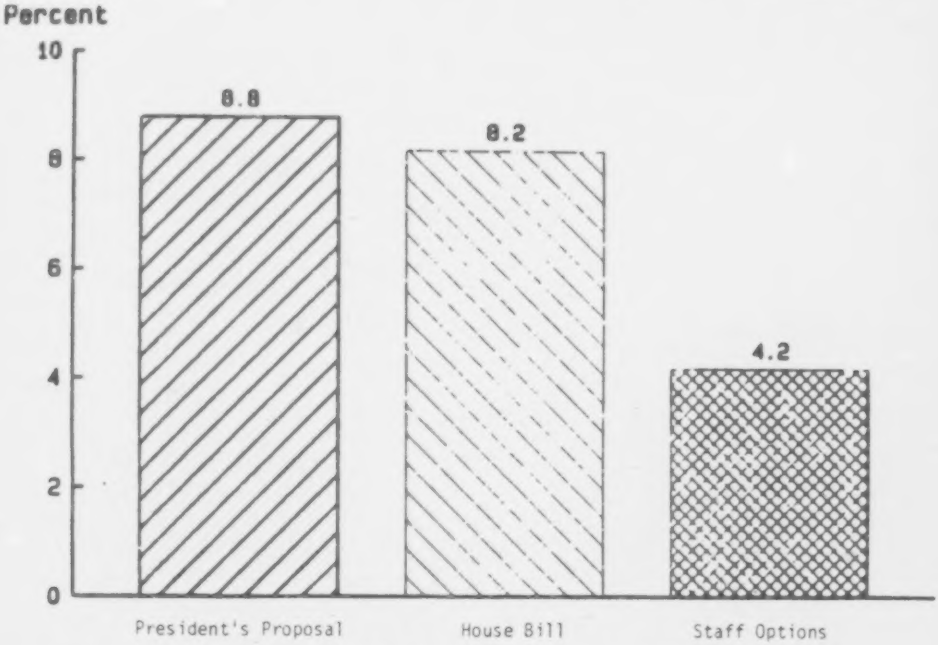
Price of widget	$ 8.00
Excise tax	$ 1.00
Gross profit (taxable income)	$ 1.00
Taxable income	$ 2.00
$2 taxable income at 35%	$ .70
After-tax profit	$ .30
Price of Product	$10.54
Price of widget	- 8.00
	2.54
$1 excise tax paid	- 1.00
	1.54
Tax paid ($2.54 profit x .35)	- .89
	.65

An anti-avoidance rule included in the proposal would result in payment of taxes by businesses that have no tax liability. The proposal is unfair as the tax increase is uneven across businesses, with unprofitable firms faced with a 35 percent tax increase and successful firms subject to a 54 percent increase.

Deductibility of excise taxes and tariffs is considered a legitimate cost of doing business. Businesses should pay income taxes on net income only, not on the cost of goods or operations. To the extent that the excise

Chart 2

Comparison of Overall Tax Cuts for all Income Classes After Excise Tax and Tariff Changes



taxes are paid out of a company's profits, to remove deductibility results in payment of an income tax on an excise tax -- a tax on a tax. Excise taxes are no different than other taxes paid as a cost of doing business. If there were any economic justification for repeal of deductibility, there would be no less justification for repealing deductibility of any costs of doing business.

The President's proposal allowed for an overall tax cut for all income classes of 8.8 percent, and the House bill contains a reduction of 8.2 percent. The deSeve Economic Associates analysis of the excise and tariff provisions shows that the excise tax and tariff increases would offset 45 percent of all individual income tax reductions in 1988.[1] Chart 2 shows that the excise tax and tariff provisions in the Senate Finance Committee proposal reduce the tax cut to only 4.2 percent.

Business As Tax Collector

Businesses pay their excise taxes to the government prior to recouping that cost by passing the tax through to consumers in price increases. This causes an additional hardship for business, which has been partially remedied by the deductibility of these excise taxes. These taxes are in no way income to the business, as they pass the tax right on to the government. To remove deductibility and place a tax on a tax penalizes businesses for being the government's tax collector.

Poor Tax Policy

Excise taxes and tariffs are selective taxes; they are placed on specific products and services. The use of selective excise taxes distorts the investment decisions made in the economy by making certain investments more expensive relative to other investments and changing the relationship of goods and services to each other based on market evaluations. This will cause businesses to make less-than-optimal investments, resulting in lower productivity, a less efficient use of resources, and reduced economic growth and job creation.

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[1] "An Analysis of the Federal Excise Tax and Tariff Proposals in the Senate Finance Committee Markup," deSeve Economics, April 1986, p.10.

Using the tax code to skew investment decisions away from the most efficient use of resources, resulting in reduced economic growth, is considered by most to be poor tax policy. Even Alexander Hamilton, arguing in The Federalist Papers some 200 years ago, said that if the federal government was restricted to one particular object of taxation (such as duties on imports), that the tax levied would be disproportionately excessive upon those objects. He perceived that this would result in the oppression of specific branches of industry and an unequal distribution of the taxes. According to Hamilton, excise taxes on specific products would "sometimes force industry out of its more natural channels into others in which it flows with less advantage."[2]

The use of selective excise taxes, which are imposed arbitrarily on various items at the whim of politicians, does nothing to promote fairness in the tax code and certainly moves away from the politicians' often-stated goal of a "level playing field."

Tax Incidence

Increases in excise taxes are primarily passed on to the consumer as price increases. As the price of a product increases due to an excise tax increase, the quantity demanded of the product declines by a certain amount.

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[2] Hamilton, Madison, and Jay, The Federalist Papers, No. 35 (New York: New American Library), p. 212.

The revenue effects from these excise tax increases will prove less than what the Treasury might estimate. Studies consistently have shown that increases in tax rates usually result in less revenue raised because of reduced investment, changes in investment patterns, or increased sheltering of investment. Experience has shown that the percentage change in revenue gained from an increase in tax rates will be less than the percentage increase in the rates.

An increase in selective excise taxes will skew demand toward any available untaxed substitutes, reducing the amount of revenue generated from the imposition of the taxes. Government estimates on revenue amounts from such tax increases usually fail to take this change of behavior into account.

International Trade Aspects

The Chamber is concerned that the proposed nondeductibility of tariffs would run counter to a U.S. Tokyo GATT round commitment to reduce tariffs over seven years. The Senate Finance Committee proposal would increase the level of effective tariff protection by 54 percent (based on a 35% tax rate) at a time when the U.S. is actively promoting a new round of multilateral trade negotiations. Moreover, the effective tariff increases resulting from the proposed legislation lend justification to retaliatory measures by our trading partners.

II. THE CHANGE TO AD VALOREM TAXATION

The Senate Finance Committee proposal to tax on the basis of increases in prices (ad valorem) rather than on the quantity of the products sold (ad rem) would result in increases in these taxes as their prices rise. Currently, as the prices of these taxed items increase, the negative effects decrease. This serves to reduce the distortionary effects caused by selective excise taxes. If the change to ad valorem taxation is allowed, this advantage would be lost.

The transition to ad valorem taxation from ad rem taxation will have an additional negative effect on business. As the costs of production rises and business must raise its prices, its tax liability will also rise. This will lock business into a vicious circle of price increases and tax increases, reducing economic growth and productivity.

CONCLUSION

The combined effects of these excise and tariff provisions would be to offset almost half of the income tax reduction promised in the current reform proposal. According to the deSeve Economics study, those in the highest bracket would lose 6 percent of their reduction, and those in the lowest bracket would lose more than 60 percent. The 77 percent income tax reduction granted to those in the lowest bracket would be reduced to 13 percent when the excise tax provisions' effects are factored into tax liability.[3]

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[3] "An Analysis of the Federal Excise Tax and Tariff Proposals in the Senate Finance Committee Markup," deSeve Economics, April 1986, p. 12.

Chart 3

Tax Reductions by Income Class Under Finance Committee Staff Proposal

Income Class ($1,000's of 1986 Dollars)	Tax Reductions As Percent of Tax Liability: 1988	
	Income Tax Only	Combined Effect of Income, Excise & Tariff Changes
0 - 10	-77.2%	-12.9%
10 - 20	-23.0	-11.1
20 - 30	- 9.7	- 4.3
30 - 50	- 8.1	- 2.8
50 - 100	- 5.7	- 2.3
100 - 200	- 4.2	- 2.8
200	- 5.9	- 5.5
Average All Classes	- 8.4%	- 4.2%

It is inconclusive whether an increase in excise taxes falls primarily on business, labor, or the consumer, or some portion of all the factors of production. Although the initial effect of the tax may be different for each, the end result will be lower economic growth for the economy as a whole.

The effect of these excise tax provisions would be to distort further any move toward an economically neutral environment, which should be a goal of tax reform, and redistribute the tax liability among industries. There has been much talk about a "level playing field" during the debate over tax reform, but increasing selective excise taxes and denying deductibility is a move in the opposite direction.

The Center for the Study of American Business, in its special analysis of the Senate Finance staff options, reported that the excise tax and tariff provisions of the options would provide an inflationary impetus to the economy.[4] When the excise taxes increase and deductibility is repealed in 1987, the staff option would raise the inflation rate 0.3 percentage points over current law.

The Chamber urges the Senate Finance Committee to discard the excise tax and tariff provisions of the committee proposal as harmful to the economy and continues to encourage the development of a tax reform proposal that is pro-economic growth and job creation.

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[4] "The Senate Finance Committee Staff Option for Tax Reform: A Macroeconomic Analysis," Center for the Study of American Business, March 25, 1986, p. 14.

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WSWA

WINE AND SPIRITS WHOLESALERS OF AMERICA, INC.

STATEMENT

of

Douglas W. Metz

Executive Vice President and General Counsel

Wine and Spirits Wholesalers of America

presented to the

Committee on Finance, U.S. Senate

April 21, 1986

Mr. Chairman and Members of the Finance Committee:

The Wine and Spirits Wholesalers of America strongly opposes proposals in the draft tax reform package that would (1) deny the deductibility of excise taxes as a business expense for determining federal income tax liability; (2) increase the federal excise tax on wine; and (3) index the federal excise taxes on alcohol beverages (and other items) to the future prices of these products.

Our Association represents nearly 800 distributors in 44 states, the District of Columbia, Puerto Rico and the Virgin Islands. Our members account for almost 90 percent of the wines and spirits sold to the retail trade in states where such products can be sold by private enterprise under license. As importers of these beverages, we pay nearly $500 million in excise taxes and duties.

Enactment of any one, or combination, of the three excise tax proposals would have devastating economic consequences for our members whose after tax profit margins have declined from 1.66 percent in 1982 to 1.24 percent in 1984. Further erosion of margins are projected in the face of continuing sales declines, exacerbated by the 19 percent increase in the federal excise tax on distilled spirits on October 1, of last year.

I can state unequivocably, based on extensive consultations with individual members of our association, that the costs entailed by enactment of any of the excise tax proposals would be treated by the wholesale industry as an additional business expense and would trigger immediate price increases to the retailer. Our suppliers, who pay the federal excise tax on domestically produced products, have indicated that any direct or indirect costs occasioned by these proposals would be reflected in their invoiced prices to the wholesaler. To preserve gross profit margins, the wholesaler would have no recourse but to treat these additional costs as acquisition costs subject to ordinary mark-up in his prices to his customers.

Likewise, for products that the wholesaler imports in-bond on which he pays excise taxes and duties, his prices would be raised to reflect mark-ups that would yield normal margins on the increased costs resulting from enactment of any or all of the excise tax proposals.

The inevitability of such price increases is demonstrated by the results of a survey sent to our members. They were asked to recalculate their federal income tax liability by excluding as a business expense excise taxes and duties paid on imported products. In nearly every instance, large, medium and small firms reported substantial losses, even if the top corporate rate were capped at 35 percent.

We consulted economists both inside and outside the industry to determine the probable consumer price impact of the excise tax proposals. They were asked to calculate the effect in prices of the non-deductibility proposal, and for wine, the effect of the proposed tax increase. The consensus is that the consumer would pay 20-25 percent more for a 1.5 liter of popularly priced table wine and for a liter of popularly priced distilled spirits. With shelf price increases of this magnitude, consumer resistance could produce a fall-off in sales of as much as 10 percent. Last year, table wine sales declined 6 percent and are now entering their third year of decline. Distilled spirits sales dropped 2 percent -- the sixth consecutive year of declining volumes.

Since most consumers of alcohol beverages are from low and middle income groups, the regressive nature of the excise tax proposals is obvious.

In closing, I would like to comment specifically on the proposal to index the federal excise tax (FET) rates for alcohol beverages, tobacco and motor fuels to price increases for each of these products. How this would operate has not been spelled out but it could have equally devastating consequences for all alcohol beverage categories. If the authors of this proposal had Canada in mind, here's what happened in our neighbor to the north.

In 1981, Canada instituted an excise tax system in which the FET's on alcohol beverages were automatically raised to match increases in the consumer price index of alcohol beverages. The adjustment was made once annually, based on average price increases for all alcohol beverages during the previous year. Under this averaging method, the FET on one beverage category could be increased even though its consumer prices did not rise. Also, if suppliers never took a second price increase, the FET would continue to rise automatically each year since previous tax increases are reflected in consumer prices in later years.

After nearly four years of an automatic spiral of tax-upon-price-upon-tax increases, the Canadian government repealed its tax indexing system.

During the period of tax indexing in Canada, FET rates rose 65 percent; demand for distilled spirits, for example, dropped by over 14 percent. In contrast, tax revenues increased only 38 percent; revenues from distilled spirits actuallly declined in the last year.

If the authors of the excise tax indexing proposal intend to use the recent Canadian system to implement tax indexing, it should be pointed out that the new FET rates on alcohol beverages in 1988 would be calculated on top of the significant price rises required in 1987 resulting from proposals to deny excise and duty deductibility.

In summary, enactment of any or all of the excise tax proposal would (1) impose enormous economic hardship on an already distressed industry; (2) aggravate the tax code's existing discriminatory treatment of industries whose products are subject to federal excise taxes; and (3) exacerbate the regressive effects of such taxes on individual taxpayers. We urge the committee to reject these proposals in the interests of tax equity and economic fairness.

# # #

WINEGRAPE GROWERS OF AMERICA, INC.
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TESTIMONY OF MONTY STAMP, PRESIDENT
WINEGRAPE GROWERS OF AMERICA, INC.
BEFORE THE SENATE FINANCE COMMITTEE
APRIL 21, 1986

TESTIMONY OF MONTY STAMP, PRESIDENT
WINEGRAPE GROWERS OF AMERICA, INC.
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I am Monty Stamp, president of the Winegrape Growers of America, Inc. Through our state associations, we represent 97 percent of the nation's winegrape growers. We appreciate this opportunity to present our views concerning the impact of your Committee's proposed excise tax on wine. The effect on our industry can be summed up in two words -- economic ruin. At a time when a farm debt crisis is gripping the nation, winegrape growers find it inconceivable that the U.S. Senate could think of passing a tax that would further depress sales of an agricultural product.

Make no mistake -- the U.S. winegrape growing industry is already in a depression. Last year, 106.6 million cases of wine were shipped, down from 116.6 million in 1984. Much of this reduction was due to a flood of cheap foreign imports, which are heavily subsidized by their governments.

The Committee proposal would effectively raise the tax on wine from its current rate of $0.17 a gallon to a hefty $0.87 a gallon. According to commonly accepted price formulas, this would decrease wine sales by 7 to 10 percent.

This translates into a 350,000 ton drop in grape sales nationally. The result would likely be the failure of 400 vineyards.

To fully understand how vulnerable winegrape growers are, you need to understand the structure of the industry. Of the approximately 1,200 wineries in this country, 1,180 are small businesses, primarily owned and operated by families who raise their own grapes and make their own wine.

These family-run operations are like small farmers everywhere -- they are already deeply in debt and one bad year could mean the difference between solvency and foreclosure. It costs about $6,000 an acre to establish a vineyard. Unlike an industrial operation, a vineyard cannot be put into storage, nor can the crop be simply plowed under like corn, wheat and other agricultural commodities. If the vineyards are abandoned or lost one year, they cannot be ressurected the next without great financial inputs.

And I might remind this Committee that the winegrape industry does not have government subsidies or other Federal programs to fall back on. Indeed, the wine industry is an $8.2 billion concern, based on an agricultural commodity, that does not receive any government subsidies. However, many vineyards are in areas where other crops are subsidized. Consequently, the winegrape grower finds himself competing for labor, farm supplies, and land without the benefit of these subsidies.

In addition to the problems this tax will cause for winegrape growers, this panel should consider several connected issues. For one thing, winegrape growers and small vintners have been responsible for the growth of a vibrant tourist trade in many rural areas, supporting bed and boards, hotels and restaurants. The death of these small vineyards, and the revenue they generate, would be catastrophic for many small businesses.

Likewise, the effect on local employment would be considerable. The 350,000 ton drop in grape sales mentioned above, would mean the abandonment of approximately 50,000 acres of grapes, and unemployment for scores of full and part-time farm workers from coast-to-coast.

This is in addition to workers and manufacturers of bottles, containers, and printing materials, as well as those engaged in wholesaling, retailing, transportation, advertising and other endeavors related to wine sales.

In addition to the concerns I have just outlined, I also think that some of the Committee's assumptions concerning this tax need to be questioned. The Committee's proposal claims that the tax on wine is too low compared to that of beer. However, 47 states already have higher excise taxes on wine than on beer. If the states follow the Committee's precedent, the impact on winegrape growers would be devasting.

Also, the Committee's tax, like most excise taxes, will come mainly out of the pocket of the poor and the middle class. Almost 80 percent of all wines are popularly priced, usually under $3.50 a bottle. The proposed tax will not be placed on a rich man's extravangance, but rather on a poor man's luxury and a beverage of moderation.

Lastly, the tax cannot be justified on the grounds of public safety either. Eighty percent of all wines are consumed at home, mainly with meals.

In summary, we urgently appeal to the Committee to reject the wine excise tax proposal. It will certainly generate some revenue, but at the expense of putting one-third of the winegrape growing industry out of business, most of which are small, family-run businesses already deeply in debt. Likewise, it could devastate many rural communities.

When Congress wrote the Farm Act of 1985, none of the winegrape growers petitioned for a subsidy. Now, we only ask not to be taxed out of business.

Thank you.

Z

POSITION PAPER
ON
CORPORATE AND GENERAL BUSINESS TAXATION
SENATE FINANCE COMMITTEE STAFF OPTION
FOR
COMPREHENSIVE TAX REFORM

IN OPPOSITION TO
FEDERAL EXCISE TAXES NOT
DEDUCTIBLE FOR INCOME TAX PURPOSES
AND
IN SUPPORT OF TARIFFS NOT DEDUCTIBLE FOR
INCOME TAX PURPOSES

ZEBCO DIVISION BRUNSWICK CORPORATION
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BACKGROUND

Zebco is the world's largest manufacturer of fishing reels in number of units. Located in Tulsa, Oklahoma, Zebco has been producing fishing reels since 1948 and is one of only three remaining manufacturers of fishing reels in America. All other manufacturers have either ceased operations or transferred to sourcing overseas. A.C. Nielson studies indicate that fishing is the nation's second largest participant sport. Over 60,000,000 Americans fish annually.

EXCISE TAX ON SPORTFISHING EQUIPMENT WAS NEVER INTENDED TO BE A REVENUE PRODUCING TAX

Zebco is one of the companies which initially supported the imposition of an excise tax on our products in 1952 and has never changed its position. The tax, which is 10% of the amount for which a taxable item is so sold, is earmarked for the Federal Aid in Fish Restoration Program previously known as the Dingel-Johnson or D-J Fund. Recently, the Trust Fund was expanded to include additional sportfishing items, a portion of the motorboat fuels tax and the import duty on sportfishing items, pleasure boats and yachts. It is now known as the Wallop-Breaux Fund. The excise tax is collected by the manufacturer or importer and paid to the Treasury Department where the Fund draws interest and at the end of a fiscal year is paid to the U.S. Fish and Wildlife Service for apportionment to the states and territories. States and territories match the federal apportionment on a three-for-one basis. The self-imposed tax was never intended to be a revenue producing tax to support operations of the Federal Government.

AN EXCISE TAX BOOST WILL HURT CONSUMERS

The seller of a taxable sportfishing product, rather than the buyer, is the one who sends excise tax Trust Fund revenue to the Treasury Department. Even so, it is the consumers who pay the tax. Should the manufacturers have to pay income tax on the Trust Fund revenue collected, the result would be the same as if excise taxes had been increased. Sellers will be forced to raise the prices which they charge consumers. Without giving effect to a detailed computation of the tax reform proposal, it appears a price increase of between 5% and 6% would be required to maintain margin. (See the example of a company in the sportfishing industry on Exhibit A)

THE IMPACT OF THE SENATE TAX PROPOSAL IS UNFAIR AND DISCRIMINATORY

Exhibit B reflects the impact of the tax proposal on a fishing tackle company. Without a price increase, the actual tax liability increases by 110% with an effective tax rate of 101.6%. The result is an after-tax loss. With a price increase to maintain margin, the tax liability increases by 179% with an effective tax rate of 69.2%. This approach to tax reform seems designed to conceal what in reality amounts to a tax increase. It is unfair and discriminatory.

EXCISE TAXES ON SPORTFISHING ITEMS ARE REGRESSIVE

If the seller would have to pay income tax on the excise tax revenues collected, the results would be the same as if excise taxes had been increased. Any plan which attempts to pay for income tax cuts by in effect increasing excise taxes does not seem to be a desired method of accomplishing tax reform. Clearly, the burden of this plan will be on low-income and middle-income taxpayers. Zebco's most recent market study indicates that in 1985 the median household income of the reel buyer was $25,800. This profile is supported by industry statistics as well.

TARIFFS ON SPORTFISHING EQUIPMENT

While the same arguments made for excise tax can be made for tariffs, Zebco supports the non-deductibility of tariffs for income tax purposes. The sportfishing industry is rapidly becoming an all import industry. Over 90% of apparent consumption of fishing rods in the U.S. is imported. Over 65% of the apparent consumption of fishing reels is imported. Fishing rods are a lost cause. The three companies making fishing reels in America still have a chance.

The non-duductibility of tariffs on fishing tackle would of course help the domestic manufacturers to remain competitive and continue to produce on shore. Perhaps this type of tax break for domestic manufacturers would encourage the return to America of the products used by over 60,000,000 sport fishermen. Please refer to Exhibit C for the history of imports of reels and rods into this country over the last ten years.

SUMMARY

Our understanding of the proposal for comprehensive tax reform as it affects the excise tax paid on sportfishing equipment does not seem to represent true tax reform. It is unfair, regressive and discriminatory. We believe true tax reform would not favor one type of taxpayer over another, one industry over another, nor one type of consumption over another.

Exhibit A

IMPACT OF SENATE TAX PROPOSAL ON A $100 MILLION ROD AND REEL COMPANY

1987 PRO FORMA FINANCIAL STATEMENT HIGHLIGHTS

		Senate Tax Proposal		
	Current Accounting (Mil)	Required Adjustments (Mil)	Without Price Increase (Mil	With A Price Increase (Mil)
Net Sales	$100.0	+ 10.0	$110.0	$116.1
Cost of Goods Sold	69.0		69.0	69.0
Gross Margin	$ 31.0		$ 41.0	$ 47.1
Operating Expenses	20.0		20.0	20.4
Non-Opr. Expenses	5.0	+ 10.0	15.0	15.0
Pre Tax Earnings	$ 6.0		$ 6.0	$11.7
Income Taxes	2.9		6.1	8.1
A/T Earnings<Loss>	$ 3.1		$<0.1>	$ 3.6
Return on Sales	3.1%		Negative	3.1%

Assumptions:
1) Excise tax under "Current Accounting" is not included in the financial statement, but is 10% of sales ($10 Million)
2) Tariffs of $1 million are included in cost of goods sold
3) Commission of 6% is included in operating expenses
4) Income taxes are federal, state, and local taxes without any timing differences or credits to simplify the comparison. Lost ITC and other credits would increase the losses vs. current accounting
5) A price increase of 5.5% is required to maintain return on sales percentage.

EXHIBIT B

IMPACT OF SENATE TAX PROPOSAL ON A $100 MILLION COMPANY

1987 TAX CALCULATIONS

		Senate Tax Proposal	
	Current Accounting (Mil)	Without Price Increase (Mil)	With Price Increase (Mil)
Reported Earnings	$ 6.0	$ 6.0	$11.7
Exclusions			
- Tariffs	-0-	1.0	1.0
- Excise Tax	-0-	10.0	10.0
Taxable Earnings	$ 6.0	$17.0	$22.7
State & Local Tax (3%)	$ 0.2	$0.2	$ 0.3
Federal Tax (46%/35%/35%)	2.7	5.9	7.8
Total Income Tax	$ 2.9	$6.1	$8.1
Effective Tax Rate	48%	101.6%	69.2%

PAGE 1

Exhibit C

FISHING REELS
VALUE $0.00 to $2.70

UNITS SOURCE	74	75	76	77	78	79	80	81	82	83	84	85	% CHG
JAPAN	2,910	1,316	1,331	1,341	820	387	183	315	236	192	351	723	105.98%
KOREA	423	360	1,120	883	575	710	914	711	1,022	1,063	1,497	964	-35.60%
HONG KONG	372	272	669	639	113	160	270	311	504	596	459	443	-3.49%
TAIWAN	343	241	461	510	441	470	493	470	700	509	914	3,292	260.18%
ENGLAND	12	13	0	0	0	0	0	0	0	0	0	0	0.00%
FRANCE	1	3	11	0	0	0	0	0	5	0	2	0	-100.00%
OTHERS	5	41	4	53	1	0	0	376	690	23	3	41	1266.67%
TOTALS	4,066	2,246	3,596	3,426	1,950	1,727	1,860	2,183	3,157	2,383	3,226	5,463	69.34%
% CHANGE		-44.8%	60.1%	-4.7%	-43.1%	-11.4%	7.7%	17.4%	44.6%	-24.5%	35.4%	69.3%	

VALUE ($000) SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
JAPAN	$4,339	$1,949	$2,072	$2,080	$1,423	$543	$289	$468	$204	$381	$428	$304	-28.97%
KOREA	$491	$445	$1,747	$1,334	$1,018	$1,285	$1,766	$1,501	$2,174	$2,122	$2,441	$1,731	-29.09%
HONG KONG	$423	$297	$812	$757	$113	$159	$571	$670	$987	$1,102	$905	$697	-22.98%
TAIWAN	$454	$412	$427	$423	$513	$644	$743	$727	$1,113	$715	$1,356	$3,671	170.72%
ENGLAND	$17	$32	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	0.00%
FRANCE	$1	$5	$28	$0	$0	$0	$0	$0	$11	$0	$1	$0	-100.00%
OTHERS	$8	$68	$4	$80	$1	$0	$0	$477	$934	$19	$1	$75	7400.00%
TOTALS	$5,733	$3,208	$5,090	$4,674	$3,068	$2,631	$3,369	$3,843	$5,423	$4,339	$5,132	$6,478	26.23%
% CHANGE		-44.0%	58.7%	-8.2%	-34.4%	-14.2%	28.1%	14.1%	41.1%	-20.0%	18.3%	26.2%	

UNIT VALUE ($000) SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
JAPAN	$1.49	$1.48	$1.56	$1.55	$1.74	$1.40	$1.58	$1.49	$0.86	$1.98	$1.22	$0.42	-65.52%
KOREA	$1.16	$1.24	$1.56	$1.51	$1.77	$1.81	$1.93	$2.11	$2.13	$2.00	$1.63	$1.80	10.12%
HONG KONG	$1.14	$1.09	$1.21	$1.18	$1.00	$0.99	$2.11	$2.15	$1.96	$1.85	$1.97	$1.57	-20.20%
TAIWAN	$1.32	$1.71	$0.93	$0.83	$1.16	$1.37	$1.51	$1.55	$1.59	$1.40	$1.48	$1.12	-24.84%
ENGLAND	$1.42	$2.46	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
FRANCE	$1.00	$1.67	$2.55	N/A	N/A	N/A	N/A	N/A	$2.20	N/A	$0.50	N/A	-100.00%
OTHERS	$1.60	$1.66	$1.00	$1.51	$1.00	N/A	N/A	$1.27	$1.35	$0.83	$0.33	$1.83	448.78%
AVG UNIT VAL	$1.41	$1.43	$1.42	$1.36	$1.57	$1.52	$1.81	$1.76	$1.72	$1.82	$1.59	$1.19	-25.46%
% CHANGE		1.3%	-0.9%	-3.6%	15.3%	-3.2%	18.9%	-2.8%	-2.4%	6.0%	-12.6%	-25.5%	

FEB-06-1986

PAGE 1

FISHING REELS
VALUE $2.70 to $8.45
UNITS

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
JAPAN	1,630	1,036	1,760	2,994	2,295	1,900	2,044	2,658	2,560	2,577	2,839	2,582	-9.05%
KOREA	19	10	312	694	1,013	1,099	1,667	1,870	2,146	2,392	2,710	2,789	2.92%
HONG KONG	50	33	313	410	64	52	32	15	27	24	46	317	589.13%
FRANCE	1,138	718	109	101	89	15	21	7	8	10	40	25	-37.50%
TAIWAN	79	102	55	80	15	9	90	44	72	192	76	482	534.21%
SWEDEN	250	38	18	19	11	10	0	1	0	0	9	0	-100.00%
W. GERMANY	77	18	1	1	0	0	0	0	0	0	14	10	-28.57%
OTHERS	35	17	14	6	5	6	5	9	13	22	1	57	5600.00%
TOTALS	3,278	1,972	2,582	4,305	3,492	3,091	3,859	4,604	4,826	5,217	5,735	6,262	9.19%
% CHANGE		-39.8%	30.9%	66.7%	-18.9%	-11.5%	24.8%	19.3%	4.8%	8.1%	9.9%	9.2%	

VALUE($000)

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
JAPAN	$7,048	$4,686	$8,128	$14,486	$12,586	$10,418	$11,531	$15,153	$14,886	$13,848	$16,275	$15,364	-5.60%
KOREA	$79	$41	$1,302	$2,996	$4,432	$5,365	$8,712	$9,535	$10,292	$11,253	$13,049	$13,236	1.43%
HONG KONG	$158	$107	$995	$1,357	$272	$268	$117	$90	$153	$116	$176	$1,290	632.95%
FRANCE	$7,276	$4,943	$529	$610	$549	$86	$133	$49	$55	$71	$226	$189	-16.37%
TAIWAN	$262	$360	$194	$288	$72	$36	$399	$195	$355	$1,004	$321	$1,908	494.39%
SWEDEN	$1,777	$260	$84	$136	$69	$69	$0	$5	$0	$0	$37	$0	-100.00%
W. GERMANY	$627	$100	$9	$8	$0	$0	$0	$0	$0	$0	$63	$47	-25.40%
OTHERS	$171	$68	$51	$19	$26	$34	$33	$58	$79	$117	$1	$294	29300.00%
TOTALS	$17,398	$10,565	$11,292	$19,900	$18,006	$16,276	$20,925	$25,085	$25,820	$26,409	$30,148	$32,328	7.23%
% CHANGE		-39.3%	6.9%	76.2%	-9.5%	-9.6%	28.6%	19.9%	2.9%	2.3%	14.2%	7.2%	

UNIT VALUE($000)

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
JAPAN	$4.32	$4.52	$4.62	$4.84	$5.48	$5.48	$5.64	$5.70	$5.81	$5.37	$5.73	$5.95	3.80%
KOREA	$4.16	$4.10	$4.17	$4.32	$4.38	$4.88	$5.23	$5.10	$4.80	$4.70	$4.82	$4.75	-1.44%
HONG KONG	$3.16	$3.24	$3.18	$3.31	$4.25	$5.15	$3.66	$6.00	$5.67	$4.83	$3.83	$4.07	6.36%
FRANCE	$6.39	$6.88	$4.85	$6.04	$6.17	$5.73	$6.33	$7.00	$6.88	$7.10	$5.65	$7.56	33.81%
TAIWAN	$3.32	$3.53	$3.53	$3.60	$4.80	$4.00	$4.43	$4.43	$4.93	$5.23	$4.22	$3.96	-6.28%
SWEDEN	$7.11	$6.84	$4.67	$7.16	$6.27	$6.90	N/A	$5.00	N/A	N/A	$4.11	N/A	-100.00%
W. GERMANY	$8.14	$5.56	$9.00	$8.00	N/A	N/A	N/A	N/A	N/A	N/A	$4.50	$4.70	4.44%
OTHERS	$4.89	$4.00	$3.64	$3.17	$5.20	$5.67	$6.60	$6.44	$6.08	$5.32	$1.00	$5.16	415.79%
AVG UNIT VAL	$5.31	$5.36	$4.37	$4.62	$5.16	$5.27	$5.42	$5.45	$5.35	$5.06	$5.26	$5.16	-1.79%
% CHANGE		0.9%	-18.4%	5.7%	11.5%	2.1%	3.0%	0.5%	-1.8%	-5.4%	3.8%	-1.8%	

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FISHING REELS
VALUE OVER $8.45
UNITS

SOURCE	74	75	76	77	78	79	80	81	82	83	84	85	% CHG
SWEDEN	401	404	454	378	357	378	370	410	351	363	417	491	17.75%
JAPAN	132	132	481	538	717	955	1,013	1,560	1,677	1,547	1,819	2,392	31.50%
FRANCE	132	273	1,054	543	546	253	234	192	162	237	146	222	52.05%
W. GERMANY	154	110	68	122	47	64	39	34	15	9	10	9	-10.00%
ENGLAND	14	13	19	11	13	17	19	18	13	23	25	27	8.00%
KOREA	0	0	0	158	60	178	95	92	235	126	213	309	45.07%
HONG KONG	0	0	0	0	0	0	37	13	0	3	4	0	-100.00%
OTHERS	6	6	21	8	5	14	6	8	6	4	6	24	300.00%
TOTALS	839	938	2,137	1,758	1,745	1,859	1,813	2,327	2,459	2,312	2,640	3,474	31.59%
% CHANGE		11.8%	127.8%	-17.7%	-0.7%	6.5%	-2.5%	28.4%	5.7%	-6.0%	14.2%	31.6%	

VALUE($000)

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
SWEDEN	$6,681	$6,267	$8,907	$8,178	$7,214	$7,604	$8,531	$8,860	$8,346	$8,159	$8,797	$10,050	14.24%
JAPAN	$1,741	$1,468	$5,478	$6,734	$8,624	$13,238	$15,761	$21,864	$26,530	$24,753	$30,912	$42,079	36.13%
FRANCE	$1,385	$2,599	$9,730	$5,282	$5,840	$2,901	$2,973	$2,128	$1,756	$2,553	$1,460	$2,146	46.99%
W. GERMANY	$1,617	$1,312	$865	$1,414	$562	$756	$525	$434	$221	$135	$141	$146	3.55%
ENGLAND	$201	$206	$275	$202	$251	$378	$523	$462	$282	$524	$565	$688	21.77%
KOREA	$0	$0	$0	$1,549	$645	$2,044	$1,120	$1,077	$2,398	$1,418	$2,295	$3,239	41.13%
HONG KONG	$0	$0	$0	$0	$0	$0	$366	$122	$0	$24	$44	$0	-100.00%
OTHERS	$67	$92	$226	$155	$89	$226	$111	$162	$284	$197	$294	$580	97.28%
TOTALS	$11,692	$11,944	$25,481	$23,514	$23,225	$27.147	$29,910	$35,109	$39,817	$37,763	$44,508	$58,928	32.40%
% CHANGE		2.2%	113.3%	-7.7%	-1.2%	16.9%	10.2%	17.4%	13.4%	-5.2%	17.9%	32.4%	

UNIT VALUE($000)

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
SWEDEN	$16.66	$15.51	$18.03	$21.63	$20.21	$20.12	$23.06	$21.61	$23.78	$22.48	$21.10	$20.47	-2.97%
JAPAN	$13.19	$11.12	$11.39	$12.52	$12.03	$13.86	$15.56	$14.02	$15.82	$16.00	$16.99	$17.59	3.52%
FRANCE	$10.49	$9.52	$9.23	$9.73	$10.70	$11.47	$12.71	$11.08	$10.84	$10.77	$10.00	$9.67	-3.33%
W. GERMANY	$10.50	$11.93	$12.72	$11.59	$11.96	$11.81	$13.46	$12.76	$14.73	$15.00	$14.10	$16.22	15.05%
ENGLAND	$14.36	$15.85	$14.47	$18.36	$19.31	$22.24	$27.53	$25.67	$21.69	$22.78	$22.60	$25.48	12.75%
KOREA	N/A	N/A	N/A	$9.80	$10.75	$11.48	$11.79	$11.71	$10.20	$11.25	$10.77	$10.48	-2.71%
HONG KONG	N/A	N/A	N/A	N/A	N/A	N/A	$9.89	$9.38	N/A	$8.00	$11.00	N/A	-100.00%
OTHERS	$11.17	$15.33	$10.76	$19.38	$17.80	$16.14	$18.50	$20.25	$47.33	$49.25	$49.00	$24.17	-50.68%
AVG UNIT VAL	$13.94	$12.73	$11.92	$13.38	$13.31	$14.60	$16.50	$15.09	$16.19	$16.33	$16.86	$16.96	0.61%
% CHANGE		-8.6%	-6.4%	12.2%	-0.5%	9.7%	13.0%	-8.5%	7.3%	0.9%	3.2%	0.6%	

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FISHING REELS
VALUE ALL CATAGORIES
UNITS

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
JAPAN	4,672	2,484	3,572	4,873	3,832	3,242	3,240	4,533	4,473	4,316	5,009	5,697	13.74%
KOREA	442	370	1,432	1,735	1,648	1,987	2,676	2,673	3,403	3,581	4,420	4,062	-8.10%
HONG KONG	422	305	982	1,049	177	212	339	339	531	623	509	760	49.31%
TAIWAN	422	343	516	590	456	479	583	514	772	701	990	3,774	281.21%
ENGLAND	26	26	19	11	13	17	19	18	13	23	25	27	8.00%
FRANCE	1,271	994	1,174	644	635	268	255	199	175	247	188	247	31.38%
SWEDEN	651	442	512	397	368	388	370	411	351	363	426	491	15.26%
W. GERMANY	231	128	69	123	47	64	39	34	15	9	24	19	-20.83%
OTHERS	46	64	39	67	11	20	11	393	709	49	10	122	1120.00%
TOTALS	8,183	5,156	8,315	9,489	7,187	6,677	7,532	9,114	10,442	9,912	11,601	15,199	31.01%
% CHANGE		-37.0%	61.3%	14.1%	-24.3%	-7.1%	12.8%	21.0%	14.6%	-5.1%	17.0%	31.0%	

VALUE($000)

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
JAPAN	$13,128	$8,103	$15,678	$23,300	$22,633	$24,199	$27,581	$37,485	$41,620	$38,982	$47,615	$57,747	21.28%
KOREA	$570	$486	$3,049	$5,879	$6,095	$8,694	$11,598	$12,113	$14,864	$14,793	$17,785	$18,206	2.37%
HONG KONG	$581	$404	$1,807	$2,114	$385	$427	$1,054	$882	$1,140	$1,242	$1,125	$1,987	76.62%
TAIWAN	$716	$772	$621	$711	$585	$680	$1,142	$922	$1,468	$1,719	$1,677	$5,579	232.68%
ENGLAND	$218	$238	$275	$202	$251	$378	$523	$462	$282	$524	$565	$688	21.77%
FRANCE	$8,662	$7,547	$10,287	$5,892	$6,389	$2,987	$3,106	$2,177	$1,822	$2,624	$1,687	$2,335	38.41%
SWEDEN	$8,458	$6,527	$8,991	$8,314	$7,283	$7,673	$8,531	$8,865	$8,346	$8,159	$8,834	$10,050	13.76%
W. GERMANY	$2,244	$1,412	$874	$1,422	$562	$756	$525	$434	$221	$135	$204	$193	-5.39%
OTHERS	$246	$228	$281	$254	$116	$260	$144	$697	$1,297	$333	$296	$949	220.61%
TOTALS	$34,823	$25,717	$41,863	$48,088	$44,299	$46,054	$54,204	$64,037	$71,060	$68,511	$79,788	$97,734	22.49%
% CHANGE		-26.1%	62.8%	14.9%	-7.9%	4.0%	17.7%	18.1%	11.0%	-3.6%	16.5%	22.5%	

AVG UNIT VALUE

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
JAPAN	$2.81	$3.26	$4.39	$4.78	$5.91	$7.46	$8.51	$8.27	$9.30	$9.03	$9.51	$10.14	6.63%
KOREA	$1.29	$1.31	$2.13	$3.39	$3.70	$4.38	$4.33	$4.53	$4.37	$4.13	$4.02	$4.48	11.39%
HONG KONG	$1.38	$1.32	$1.84	$2.02	$2.18	$2.01	$3.11	$2.60	$2.15	$1.99	$2.21	$2.61	18.29%
TAIWAN	$1.70	$2.25	$1.20	$1.21	$1.28	$1.42	$1.96	$1.79	$1.90	$2.45	$1.69	$1.48	-12.73%
ENGLAND	$8.38	$9.15	$14.47	$18.36	$19.31	$22.24	$27.53	$25.67	$21.69	$22.78	$22.60	$25.48	12.75%
FRANCE	$6.82	$7.59	$8.76	$9.15	$10.06	$11.15	$12.18	$10.94	$10.41	$10.62	$8.97	$9.45	5.35%
SWEDEN	$12.99	$14.77	$17.56	$20.94	$19.79	$19.78	$23.06	$21.57	$23.78	$22.48	$20.74	$20.47	-1.30%
W. GERMANY	$9.71	$11.03	$12.67	$11.56	$11.96	$11.81	$13.46	$12.76	$14.73	$15.00	$8.50	$10.16	19.50%
OTHERS	$5.35	$3.56	$7.21	$3.79	$10.55	$13.00	$13.09	$1.77	$1.83	$6.80	$29.60	$7.78	-73.72%
TOTALS	$4.26	$4.99	$5.03	$5.07	$6.16	$6.90	$7.20	$7.03	$6.81	$6.91	$6.88	$6.43	-6.50%
% CHANGE		17.2%	0.9%	0.7%	21.6%	11.9%	4.3%	-2.4%	-3.1%	1.6%	-0.5%	-6.5%	

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FISHING RODS
U.S. IMPORTS FOR CONSUMPTION
UNITS

SOURCE	74	75	76	77	78	79	80	81	82	83	84	85	% CHG
TAIWAN	1,519	1,047	2,144	3,095	2,865	2,809	3,618	3,788	5,180	4,413	5,554	6,902	24.27%
JAPAN	1,223	1,396	1,404	1,513	1,454	913	616	520	1,282	667	903	1,007	11.52%
KOREA	677	563	1,224	2,140	2,180	2,221	2,595	2,876	4,082	5,657	7,126	6,781	-7.65%
OTHERS	924	397	593	563	424	733	695	564	449	794	1,061	885	-16.59%
TOTALS	4,343	3,403	5,365	7,411	6,923	6,676	7,524	7,748	10,993	11,531	14,644	15,575	4.99%
% CHANGE		-21.6%	57.7%	38.1%	-6.6%	-3.6%	12.7%	3.0%	41.9%	4.9%	27.0%	5.0%	

VALUE($000)

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
TAIWAN	$2,985	$2,403	$5,374	$9,761	$9,536	$10,052	$12,623	$14,970	$22,286	$19,492	$27,214	$35,214	29.40%
JAPAN	$3,914	$3,908	$4,541	$6,016	$5,119	$3,664	$3,194	$2,328	$3,899	$4,081	$6,563	$9,779	49.00%
KOREA	$1,793	$1,702	$3,231	$5,852	$6,590	$7,826	$9,922	$10,615	$15,835	$17,488	$24,930	$24,483	-1.79%
OTHERS	$1,623	$981	$1,274	$1,418	$755	$1,321	$1,057	$1,259	$467	$1,024	$1,416	$1,538	8.62%
TOTALS	$10,315	$8,994	$14,420	$23,047	$22,000	$22,863	$26,796	$29,172	$42,487	$42,085	$60,123	$71,014	18.11%
% CHANGE		-12.8%	60.3%	59.8%	-4.5%	3.9%	17.2%	8.9%	45.6%	-0.9%	42.9%	18.1%	

UNIT VALUE($000)

SOURCE	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	% CHG
TAIWAN	$1.97	$2.30	$2.51	$3.15	$3.33	$3.58	$3.49	$3.95	$4.30	$4.42	$4.90	$5.10	4.12%
JAPAN	$3.20	$2.80	$3.23	$3.98	$3.52	$4.01	$5.19	$4.48	$3.04	$6.12	$7.27	$9.71	33.61%
KOREA	$2.65	$3.02	$2.64	$2.73	$3.02	$3.52	$3.82	$3.69	$3.88	$3.09	$3.50	$3.72	6.34%
OTHERS	$1.76	$2.47	$2.15	$2.14	$1.78	$1.80	$1.52	$2.23	$1.04	$1.29	$1.33	$1.74	30.22%
AVG UNIT VAL	$2.38	$2.64	$2.69	$3.11	$3.18	$3.42	$3.56	$3.77	$3.86	$3.65	$4.11	$4.62	12.50%
% CHANGE		11.3%	1.7%	15.7%	2.2%	7.8%	4.0%	5.7%	2.7%	-5.6%	12.5%	12.5%	

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